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IN THE

Supreme Court of the United States

October Term, [redacted] 1969

No. [redacted] 224

THEODORE J. GOTTHELF and TOBY GOTTHELF,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

October Term, 1968

No.

THEODORE J. GOTTHELF and TOBY GOTTHELF,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Harvey M. Sklaver, on behalf of Theodore J. Gotthelf and Toby Gotthelf, prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit.

Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit (Appendix B, *infra*, pp. 3a-9a) is reported at 407 F.2d 491, 23 AFTR2d 69-549. The opinion of the Tax Court of the United States (Appendix C, *infra*, pp. 10a-17a) is reported at 48 T.C. 690.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit was entered on January 28, 1969 (Appendix D, *infra*, p. 18a). By order of that Court dated March 4, 1969, the time within which Theodore J. Gotthelf and Toby Gotthelf might file a Petition for Rehearing was extended until March 7, 1969 (Appendix E, *infra*, p. 19a), and on March 13, 1969 the Petition for Rehearing was denied (Appendix F, *infra*, p. 20a). The jurisdiction of this court is invoked under 26 U.S.C. 7482(a) and 28 U.S.C. 1254.

Questions Presented

1. Whether section 71(b) of the Internal Revenue Code of 1954 prohibits any construction of ambiguous child support provisions in a separation agreement, with the result that payments under ambiguous provisions are *per se* not fixed for the support of minor children.

2. Whether, assuming the first question is answered in the negative,

a) the Courts below disregarded the clear meaning of *Commissioner* v. *Lester*, 366 U.S. 299, when they held that the separation agreement in issue fixed an amount for the support of minor children, even though the former wife was permitted to use all or a portion of that amount for her own benefit and enjoyment, or

b) the Courts below improperly failed to apply the New York rules of construction of separation agreements as required by *Commissioner* v. *Bosch*, 387 U.S. 456.

Statutes Involved

The pertinent statutes involved are sections 71(a), 71(b) and 215 of the Internal Revenue Code of 1954, and are printed in Appendix A, *infra*, pp. 1a-2a.

Statement

Sara and Theodore Gotthelf were married on July 20, 1951. During their marriage they had two children, Nicoll Beatrice Gotthelf, born on July 28, 1955, and Eric Van Gotthelf, born on October 24, 1956. On March 28, 1958, Sara and Theodore Gotthelf entered into a separation agreement and on April 3, 1958 they were divorced. The separation agreement was incorporated by reference in the divorce decree.

Pursuant to that separation agreement, during the year 1960, Theodore Gotthelf, the petitioner herein, made payments to his former wife in the amount of $11,400 and on his joint income tax return with his new wife deducted that amount as alimony pursuant to section 215 of the Code.[1] The former wife, Sara N. Gotthelf, included $4,400 in gross income as alimony under section 71(a) and excluded $7,000 as child support under section 71(b) of the Code.

The provisions of the separation agreement relating to the payments in issue are set forth in paragraph 5 thereof and read as follows:

> 5(a) In addition to the provisions heretofore made in Paragraph "4", the husband will hereafter pay to the wife, so long as she shall remain alive and does not remarry, the sum of Twelve Thousand ($12,000.00) Dollars annually as and for her support and for the support, care (including, but not by way of limitation, medical care and expenses), maintenance and education of the children of the marriage. Payment of the aforesaid sum shall be made in equal monthly installments of One Thousand ($1,000.00) Dollars each on the 1st day of each month in ad-

[1] On their joint return for 1960, Theodore and Toby Gotthelf deducted $12,000 which is the amount set forth in the separation agreement. It is conceded that they are not entitled to deduct any amount in excess of $11,400.

vance. Such monthly payments will be mailed to the wife at 462-41 Powell's Cove Boulevard, Beechhurst, Borough of Queens, City of New York, unless the husband is advised by the wife of a different mailing address.

(b) In the event that the parties become divorced, and that the wife thereafter remarries, then the amount which the husband shall pay the wife for the purposes stated in 5(a) of this agreement shall be reduced to the sum of Seven Thousand ($7,000.00) Dollars annually, to be paid in equal monthly instalments, subject to the further provisions of paragraph 5(c) of this agreement.

(c) When either child reaches the age of twenty-one years, or in the event of the death or marriage of either child before he or she becomes twenty-one years of age, or in the event that either child is no longer living under the care and supervision of the mother (*e.g.*, if either child is in the military forces), then the amount which the husband shall pay the wife shall be reduced by Thirty-five Hundred ($3,500.00) Dollars on an annual basis for each child, so that when both children reach the age of twenty-one years, or have died or have married before they reach the age of twenty-one years, or are no longer living under the care and supervision of the mother (*e.g.*, if in the military forces) (and in the event that the wife has not remarried), then the sole obligation of the husband will be to pay the wife the sum of Five Thousand Dollars ($5,000.00) annually, payable in equal monthly installments.

In addition to the provisions in the main portion of the agreement, there was attached a rider reading as follows:

"This agreement shall be binding on the Estate of the husband to the extent of the payment of Seven

> Thousand ($7,000.00) Dollars for the benefit of the two children, as in this agreement provided for."

The agreement was executed in New York where both parties and the children resided and where they continue to reside.

The Tax Court held that in the absence of the foregoing rider no part of the annual $12,000 payments would qualify as child support under section 71(b) since paragraph 5 did not "fix" or "specifically designate" an amount for the support of the children, *Commissioner* v. *Lester*, 366 U.S. 299 (1961). However, despite the fact that the rider was not to take effect until the husband's death and even then was subject to contingencies, the Tax Court held that the addition of the rider at the end of the agreement did fix or specifically designate an amount during the husband's lifetime. In view of its determination that section 71(b) applied to $7,000, the Tax Court denied the deduction for that amount which the husband claimed under section 215.

On review, the United States Court of Appeals for the Second Circuit affirmed. It viewed paragraph 5 of the agreement (*supra*, pp. 3-4) as being ambiguous and framed the issue before it as follows:

> "The question, therefore, is whether the addition of the rider clause cures the ambiguity or defect. We agree with the conclusion of the Tax Court that it does." (Appendix B, *infra*, at p. 8a.)

Reasons for Granting the Writ

1. In determining whether amounts paid by a husband to a wife pursuant to a separation agreement constitute alimony under section 71(a) of the Internal Revenue Code of 1954 or payments to support minor children under section 71(b), this Court stated on *Commissioner* v. *Lester*, 366 U. S. 299, 301:

> "* * * We have concluded that Congress intended that, to come within the exception portion of section 22(k) [of the Internal Revenue Code of 1939 which is section 71(b) of the Internal Revenue Code of 1954], the agreement providing for the periodic payments *must specifically state* the amounts or parts thereof allocable to the support of the children. * * *" (Emphasis supplied.)

This Court, in *Lester*, dealt with a separation agreement provision similar to paragraph 5 of the Gotthelf agreement in issue. This Court did not hold that the provision was ambiguous but only that it did not "fix" or "earmark" any amount for the sole use of the children.[2] It said that child support payments under section 71(b) of the Code must be " 'specifically designated' and not left to determination by inference or conjecture" (366 U.S. 299, 306) and thus established a *per se* rule. When the Court below held the provision to be ambiguous or defective it thereby precluded itself from construing the agreement.

2. The underlying issue in this case is whether the rider clause (*infra*, p. 5) could affect paragraph 5 of the separation agreement at a time that the husband was still alive. In this connection, the Court below stated (Appendix B, *infra*, p. 8a):

> "* * * Although clearer language in the agreement such as '$12,000 annually, consisting of $5,000 for her support and $7,000 for the support, care, maintenance and education of the children' would have been preferred, and would have saved the parties considerable litigation, the rider, in our opinion, achieves the same result."

Thus, the Court below reverted to the "sufficiently clear purpose" construction of section 71(b) which this Court rejected in *Lester*.

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[2] It is worthy of note that in the case at bar the Tax Court recognized that absent the rider clause the annual $7,000 payments under paragraph 5 would not qualify as child support under section 71(b). (Appendix C, *infra*, at p. 15a).

The short answer to the Court below is that since the agreement was not written as the Court suggested, different rights attached. Under the language suggested by the Court below, the wife would have been required to use $7,000 solely for the benefit of the children and not for herself, but under the actual language of the agreement she could use all or any portion thereof for her own benefit (see the New York cases cited *infra*, pp. 7-8). Under the actual agreement the wife had complete enjoyment of the entire $12,000 and under basic precepts of the income tax law,

> " 'the income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as income, whether he sees fit to enjoy it or not.' *Corliss* v. *Bowers*, 281 U. S. 376, 378 (1930). Under the type of agreement here, the wife is free to spend the monies paid as she see's fit. 'The power to dispose of income is the equivalent of ownership of it.' *Helvering* v. *Horst*, 311 U. S. 112, 118 (1940)." (*Lester*, 366 U. S. 299, 303-304).

The logical progression of the holding by the Court below that the rider clause cured the ambiguity or defect existing in paragraph 5 of the agreement is that $7,000 a year was required to be used by the wife solely for child support, (*Weil* v. *Commissioner*, 240 F.2d 497, *Van Oss* v. *Commissioner*, 377 F.2d 812), a result contrary to the settled law of New York (see *infra*, pp. 7-8). In effect, the Court below was determining property rights from which federal tax consequences will flow. But, in determining those property rights the Court below omitted consideration of the New York law as expressed by the highest Court in that State, the Court below thereby disregarding this Court's requirement enunciated in *Commissioner* v. *Bosch*, 387 U. S. 456. If the Court below had applied the New York law as enunciated by the highest Court of the State, it would have concluded that the Gotthelf separation agreement, including the rider clause, did not require that any amount be used by the wife solely for the support of the children, *Nichols*

v. *Nichols*, 306 N.Y. 490 and *Rehill* v. *Rehill*, 306 N.Y. 126. Other New York cases related to the problem are *Orlick* v. *Orlick*, 70 App. Div. 592, *Ben Ami* v. *Ben Ami*, 8 N.Y.2d 885, aff'g 9 A.D.2d 646, *Kendall* v. *Kendall (Action No. 1)*, 200 App. Div. 702 and *In re Brooklyn Trust Company*, 163 Misc. 117.

Conclusion

The decision below is manifestly incorrect. Under the *Lester* analysis of section 71(b) the Court below was not permitted to construe the ambiguous agreement. However, even if construction is permitted the decision is erroneous under the basic precepts of the income tax law. Also, the Court below failed to apply the New York rules of construction under *Commissioner* v. *Bosch, supra,* and if it had done so, the Court below would have reached the conclusion that the agreement did not specifically designate any amount for the support of children. This Court may consider it appropriate, therefore, to grant certiorari and reverse the judgment without further briefs or argument.

Respectfully submitted,

HARVEY M. SKLAVER,
Attorney for Petitioners.

June 9, 1969

APPENDIX A

(Statutes Involved)

INTERNAL REVENUE CODE OF 1954:

SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) General Rule.—

(1) Decree of Divorce or Separate Maintenance.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

(2) Written Separation Agreement.—If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). * * *

(b) Payments to Support Minor Children—Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or

agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) General Rule.—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. * * *

APPENDIX B

(Opinion of United States Court of Appeals for the Second Circuit)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 83-5—September Term, 1968.
(Argued October 15, 1968 Decided January 28, 1969.)

Docket Nos. 32363-5

Docket No. 32,363

Cal. No. 83

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

against

SARA N. GOTTHELF,

Respondent.

Docket Nos. 32,364-5

Cal. Nos. 84-5

THEODORE J. GOTTHELF and TOBY GOTTHELF,

Petitioners,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

WATERMAN and MOORE, *Circuit Judges;*
BONSAL,* *District Judge.*

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* Of the Southern District of New York, sitting by designation.

Appendix B—Opinion of United States Court of Appeals for the Second Circuit

Appeal from a decision of the Tax Court, 48 T. C. No. 67, Arnold Raum, *Judge*, holding petitioners Theodore J. Gotthelf and Toby Gotthelf deficient in income tax due for the taxable year 1960, in the amount of $1,320.87. The Tax Court decision found that a separation agreement between Theodore and his former wife Sara Gotthelf, when coupled with an attached rider clause, "fixed" a sum certain for the support of their two minor children and was, therefore, neither deductible by Theodore nor includible in Sara's gross income.

Affirmed.

HARVEY M. SKLAVER, New York, N. Y., *for petitioners Theodore J. Gotthelf and Toby Gotthelf.*

RICHARD M. ROBERTS, Acting Assistant Attorney General, Washington, D. C. (Lee A. Jackson, C. Guy Tadlock, Marian Halley, Washington, D. C., attorneys, on the brief), *for Commissioner of Internal Revenue Service as petitioner and respondent.*

SEYMOUR REITKNEICHT, New York, N. Y., *for respondent Sara N. Gotthelf.*

MOORE, *Circuit Judge:*

Theodore and Toby Gotthelf appeal from a decision of the Tax Court entered on November 24, 1967, which found a deficiency in income tax due from them for the taxable year 1960 in the acount of $1,320.87. The question presented for review is whether the provisions of a separation agreement between Theodore and Sara Gotthelf, his former wife, "fixed" a certain amount of money exclusively for the support of their two minor children.

The pertinent facts were stipulated, and incorporated by reference into the Tax Court's findings of fact. Sara

and Theodore were married in 1951. They had two children, Nicole and Eric, born in 1955 and 1956, respectively. On March 28, 1958, they entered into a separation agreement. Divorce followed a week later and the separation agreement was incorporated by reference into the decree of divorce. The portion of that agreement important to this case reads as follows:

> 5 (a) In addition to the provisions heretofore made in Paragraph "4", the husband will hereafter pay to the wife, so long as she shall remain alive and does not remary, the sum of Twelve Thousand ($12,000.00) Dollars annually as and for her support and for the support, care (including, but not by way of limitation, medical care and expenses), maintenance and education of the children of the marriage. Payment of the aforesaid sum shall be made in equal monthly installments of One Thousand ($1,000.00) Dollars each on the 1st day of each month in advance. * * *
>
> (b) In the event that the parties become divorced and that the wife thereafter remarries, then the amount which the husband shall pay the wife for the purposes stated in 5 (a) of this agreement shall be reduced to the sum of Seven Thousand ($7,000.00) Dollars annually to be paid in equal installments, subject to the further provisions of paragraph 5 (c) of this agreement.
>
> (c) When either child reaches the age of twenty-one years, or in the event of the death or marriage of either child before he or she becomes twenty-one years of age, or in the event that either child is no longer living under the care and supervision of the mother (e.g., if either child is in the military

> forces), then the amount which the husband shall pay the wife shall be reduced by Thirty-Five Hundred ($3,500.00) Dollars on an annual basis for each child, so that when both children reach the age of twenty-one years, or have died or have married before they reach the age of twenty-one years, or are no longer living under the care and supervision of the mother (e.g., if in the military forces) (and in the event that the wife has not remarried), then the sole obligation of the husband will be to pay the wife the sum of Five Thousand ($5,000.00) Dollars annually, payable in equal monthly installments.

Equally important is the rider attached to the agreement:

> This agreement shall be binding on the Estate of the husband to the extent of the payment of Seven Thousand ($7,000.00) Dollars for the benefit of the two children, as in this agreement provided for.

In his income tax return for the year 1960 Theodore, filing jointly with his present wife Toby, claimed a deduction of $12,000 for "Alimony" paid by him to Sara for that year pursuant to the terms of the above agreement. The Commissioner determined, and Theodore thereafter conceded, that the amount actually paid to Sara was $11,400. In any event, the Commissioner found that $7,000 of this amount was for child support rather than for alimony and was, therefore, not deductible by Theodore under the provisions of the Internal Revenue Code of 1954 which allows a deduction for the amount of alimony paid to a divorced spouse (26 U.S.C. § 215(a)) even if used for purposes of child support (26 U. S. C. § 71(a)) unless the terms of the separation agreement "fix" the amount to be paid for child

support. Theodore contested this determination in the Tax Court proceeding below, contending that the entire $11,400 was deductible.

Sara's income tax return for 1960 included $4,400 as alimony received from Theodore. Following a determination by the Commissioner that the entire $11,400 paid to her that year was alimony and therefore includible in her gross income, she asked the Tax Court to find that $7,000 of the total was for child support and therefore not includible in her gross income under the provisions of 26 U. S. C. § 71(b).

The Tax Court, considering both of the Commissioner's determinations in a consolidated proceeding, held that the $7,000 was neither deductible by Theodore nor includible in Sara's gross income. In this appeal from that decision, Theodore contends that the agreement, even when coupled with the rider, did not "fix" an amount for the support of the minor children pursuant to § 71(b), which provides that a divorce wife need not include in gross income " . . . that part of any payment which the terms of the decree, instrument or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband."

Construing this statute in *Commissioner* v. *Lester*, 366 U. S. 299, 303 (1960), the Supreme Court said:

> "The agreement must expressly specify or 'fix' a sum certain or percentage of the payment for child support before any of the payment is excluded from the wife's income. The statutory requirement is strict and carefully worded. It does not say that 'a sufficiently clear purpose' on the part of the parties is sufficient to shift the tax. It says that the 'written instrument' must 'fix' that 'portion

"of the payment" which is to go to the support of the children. Otherwise, the wife must pay the tax on the whole payment."

As pointed out by the Tax Court, the plain implication of the agreement is that $7,000 was intended for the support, care and maintenance of the children and $5,000 for the support of Sara; in the event Sara would remarry, the aggregate annual payment would be reduced to $7,000; in the event that a child reaches the age of 21, marries, dies or is no longer living under the supervision of Sara's household, the aggregate payment would be reduced by $3,500; and in the event that Sara did not remarry and both children were no longer entitled to support because of the reasons just mentioned, Sara would receive $5,000.

The question, therefore, is whether the addition of the rider clause cures the ambiguity or defect. We agree with the conclusion of the Tax Court that it does. The language of the rider binding Theodore's estate to the extent of $7,000 "for the benefit of the two children *as in this agreement provided for*" makes specific that which would otherwise have been left for inference. The rider was executed on the same day as the original agreement and there can be no question that it refers back to Paragraph 5 of the agreement. Although clearer language in the agreement such as "$12,000 annually, consisting of $5,000 for her support and $7,000 for the support, care, maintenance and education of the children" would have been preferred, and would have saved the parties considerable litigation, the rider, in our opinion, achieves the same result.

The cases of this circuit cited by Theodore, all of which holds that the amount of money used for child support was not "fixed" in the agreement, are distinguishable and do not hinder our conclusion. In *Van Oss* v. *Commissioner*, 377 F. 2d 812, 814 (2d Cir. 1967), there was no provision in the agreement for the reduction of payments to the wife

if the children died or ceased to reside with their mother. Similarly, in *Weil* v. *Commissioner*, 240 F. 2d 584, 588 (2d Cir. 1957) and *Hirshon's Estate* v. *Commissioner*, 250 F. 2d 497 (2d Cir. 1957) (PER CURIAM)—both pre-*Lester* cases—payments to the wife were not to be reduced whenever a child left the household. In *Weil*, the agreement specifically provided that all payments to the wife might continue despite the children's death, majority or absence from the wife's household. In *Hirshon's* Estate the sums paid to the wife were available for her own use regardless of what the child did, so long as she, the wife, did not remarry.

The decision of the Tax Court is affirmed.

APPENDIX C

(Opinion of Tax Court of the United States)

48 T. C. No. 67

TAX COURT OF THE UNITED STATES

SARA NICOLL GOTTHELF,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

THEODORE J. GOTTHELF and TOBY GOTTHELF,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket Nos. 5921-65, 6269-65. Filed August 11, 1967.

Held, payments aggregating $7,000 a year (out of a larger total) by a husband to his divorced wife were for the support of their two minor children and were neither includible in her gross income nor deductible by him. An agreement providing for these payments contained a rider, which sufficiently "fixed" or specified such payments as child support so as to meet the requirements of *Commissioner* v. *Lester,* 366 U.S. 299, and to qualify as child support under section 71(b), I.R.C. 1954.

SEYMOUR REITKNECHT, for the petitioner in Dock No. 5921-65.

HARVEY L. GARDNER, for the petitioners in Docket No. 6269-65.

JAY HAMELBURG, for the respondent.

OPINION

RAUM, *Judge:* The Commissioner determined the following deficiencies in the income tax of petitioners for the year 1960:

Sara Nicoll Gotthelf	$2,092.37
Theodore J. and Toby Gotthelf ...	1,632.87

Appendix C—Opinion of Tax Court of the United States

The sole question for decision is whether $7,000 out of a total of $11,400 paid in 1960 by a divorced husband to his former wife, pursuant to a separation agreement, is deductible as alimony by the husband and includible in the income of the divorced wife under the provisions of section 71(a) and 215 of the 1954 Code, or whether the payment of that $7,000 represents child support under section 71(b), which is neither deductible by the husband nor includible in the income of the wife.[1]

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[1] SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) General Rule.—

(1) Decree of Divorce or Separate Maintenance.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic pyaments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in dischage of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

(2) Written Separation Agreement.—If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). * * *

* * *

(b) Payments to Support Minor Children.—Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount

The pertinent facts have been stipulated, and, as stipulated, are incorporated herein by reference as our findings of fact.

Petitioner Sara Nicoll Gotthelf filed her Federal income tax return for 1960 with the district director of internal revenue, Manhattan District, New York. Petitioners Theodore J. Gotthelf and Toby Gotthelf filed their joint Federal income tax return for 1960 with the district director of internal revenue, Brooklyn, New York. All petitioners were residents of New York when the petitions herein were filed.

Sara and Theodore were married on July 20, 1951. They had two children, Nicole Patrice Gotthelf, born on July 28, 1955, and Eric Van Gotthelf, born on October 24, 1956. On March 28, 1958, Sara and Theodore entered into a separation agreement. They were divorced on April 3, 1958, and the separation agreement was incorporated in the decree of divorce by reference. The agreement provided in part as follows:

> 5 (a) In addition to the provisions heretofore made in Paragraph "4", the husband will hereafter pay to the wife, so long as she shall remain alive and does not remarry, the sum of TWELVE THOUSAND ($12,000.00) DOLLARS annually as and for her support and for the support, care (including, but not by way of limitation, medical care and expenses),

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specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) General Rule.—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. * * *

maintenance and education of the children of the marriage. Payment of the aforesaid sum shall be made in equal monthly installments of ONE THOUSAND ($1,000.00) DOLLARS each on the 1st day of each month in advance. * * *

(b) In the event that the parties become divorced, and that the wife thereafter remarries, then the amount which the husband shall pay the wife for the purposes stated in 5 (a) of this agreement shall be reduced to the sum of SEVEN THOUSAND ($7,000.00) DOLLARS annually, to be paid in equal monthly installments, subject to the further provisions of paragraph 5 (c) of this agreement.

(c) When either child reaches the age of twenty-one years, or in the event of the death or marriage of either child before he or she becomes twenty-one years of age, or in the event that either child is no longer living under tthe care and supervision of the mother (e.g., if either child is in the military forces), then the amount which the husband shall pay the wife shall be reduced by THIRTY FIVE HUNDRED ($3,500.00) DOLLARS on an annual basis for each child, so that when both children reach the age of twenty-one years, or have died or have married before they reach the age of twenty-one years, or are no longer living under the care and supervision of the mother (e.g., if in the military forces) (and in the event that the wife has not remarried), then the sole obligation of the husband will be to pay the wife the sum of FIVE THOUSAND DOLLARS ($5,000.00) annually, payable in equal monthly installments.

A rider attached to the agreement reads as follows:

> This agreement shall be binding on the Estate of the husband to the extent of the payment of SEVEN THOUSAND ($7,000.00) DOLLARS for the benefit of the two children, as in this agreement provided for.

The agreement, dated March 28, 1958, consisted of eight numbered pages signed on page 8 by Theodore and Sara, followed by the rider on a separate page numbered 8-A, also signed by Theodore and Sara, followed in turn by an unnumbered page in which the signatures of Theodore and Sara on the "foregoing instrument" were notarized. The signatures of both parties were thus notarized on March 28, 1958. The sheet containing the notarizations was in turn followed by two unnumbered sheets containing two exhibits. The eight numbered sheets, the rider on page 8-A, the notarization sheet and the two exhibits were all bound together in the foregoing sequence.

In the income tax return filed by Theodore and Toby Gotthelf for the year 1960 they claimed a deduction of $12,000 for "Alimony" paid by Theodore to Sara during that year pursuant to the separation agreement. The Commissioner determined that the payments to Sara amounted to $11,400 and that $7,000 of this amount was for child support and was not deductible by Theodore and Toby Gotthelf under the provisions of sections 71 and 215. In their petition Theodore and Toby concede that the payments made to Sara in 1960 amounted to $11,400. They contend that this amount is deductible by them as alimony.

In the income tax return filed by Sara for the year 1960 she included $4,400 in her income as alimony received from Theodore. The Commissioner determined that the entire $11,400 received by her from Theodore during that year constituted alimony which was includible in her gross

income. She contends that $7,000 of this amount was for child support and was, therefore, not includible in her gross income under the provisions of section 71(b).

We are satisfied that, in the absence of the rider on page 8-A, the $7,000 payment would not qualify as child support under section 71(b), in accordance with *Commissioner* v. *Lester*, 366 U.S. 299. Cf. *Van Oss* v. *Commissioner*, — F. 2d — (C.A. 2). True, the plain implication of paragraph 5(a), (b), and (c) of the agreement is that such payment was intended as child support. Thus, $12,000 a year is to be paid annually to the wife for her support as well as "for the support, care * * *, maintenance and education" of the two children; but, in the event of the wife's remarriage, the aggregate annual payment is to be reduced to $7,000; and, in the event that a child reaches the age of 21, or dies or marries, or is no longer living under the care and supervision of the mother, the annual amount payable by the husband to the wife is to be reduced by $3,500. Here, then, is a clear indication that the parties to the agreement intended the $12,000 to be composed of $5,000 for the support of the wife and $7,000 for the support of the two children. But, under *Lester*, we are not permitted to indulge in any such interpretation of the agreement. Section 71(b) provides that the agreement must "fix, in terms of an amount of money or a part of the payment" the sum which is claimed to represent child support, and *Lester* holds that these provisions must be applied literally. It is not enough that there be "a sufficiently clear purpose" as to the amount or portion allocable to child support; the decree or written instrument incident to the divorce must "specifically designate" or "fix" the amount or portion which is to be applied to the support of the children. 366 U.S. at pp. 303, 305.

Does the addition of the rider on page 8-A cure the defect? We think it does. Although crudely drafted, the

rider does supply the specificity otherwise missing in paragraph 5. It removes any possible doubt that $7,000 represents child support. Paragraph 5(a) designates $12,000 for the wife's support "and for the support, care * * *, maintenance and education of the children", but it does not state in specific terms what portion of that aggregate amount is thus to be devoted for the children's benefit. Although the parties understood what portion was to be thus devoted, as revealed by subparagraphs (b) and (c), the amount allocable to the children was specifically set forth in the rider as $7,000.

To be sure, the purpose of the rider appears to have been to make certain that the $7,000 obligation in respect of the children would be binding on the father's estate in the event of his death. But it specified, beyond all ambiguity, that the amount "for the benefit of the two children, as in this agreement provided for", i.e., for their "support, care * * *, maintenance and education" was $7,000. It made specific that which would have been left to inference in its absence, and thus supplied what was lacking in *Lester*.

Certainly, if the pertinent language of paragraph 5(a) had read "$12,000 annually, consisting of $5,000 for her support and $7,000 for the support, care * * *, maintenance and education of the children," there could be no dispute that the $7,000 would qualify as child support under section 71(b). We think that the rider achieves precisely this result. Although ineptly drawn, it does specify $7,000 as the amount "payable for the benefit of the two children"; that language in turn is modified by the words "as in this agreement provided for," and those words in turn are referable only to the provisions of paragraph 5. Thus, the provisions for child support in paragraph 5 are equated in the rider to the words "for the benefit of the two children," and the amount thereof is specifically fixed at

$7,000. The rider itself was executed as part of the original agreement on the same day, March 28, 1958, and the $7,000 figure therein is just as much a part of that agreement as though it had appeared in paragraph 5. It is a matter of no consequence that the rider was intended to spell out an obligation after the father's death, for, in the course of so doing, it also amplified the language of paragraph 5 so as to nail down the amount payable for the support of the children. In the circumstances, we conclude that the agreement did "fix, in terms of an amount of money" the sum payable for the support of the two children, as required by section 71(b).

We reach this conclusion without reliance upon any of the evidence presented by the wife showing that the subsequent conduct of the parties themselves, the positions urged by them in subsequent litigation, and the judicial action taken in such subsequent litigation, were all upon the basis that $7,000 represented child support. That evidence, under *Lester* and section 71(b), was irrelevant, since the amount allocable to child support must appear explicitly in the instrument itself; however, it is interesting to note that such evidence in fact confirms the result that we reach.

Decision will be entered under Rule 50.

APPENDIX D

(Judgment of the United States Court of Appeals for the Second Circuit)

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-eighth day of January, one thousand nine hundred and sixty-nine.

Present:

HON. STERRY R. WATERMAN,
HON. LEONARD P. MOORE,
Circuit Judges,

HON. DUDLEY B. BONSAL,
District Judge.

THEODORE J. GOTTHELF and TOBY GOTTHELF,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPEAL FROM THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed,

.....
Clerk

APPENDIX E

(Order Extending Time to File Petition for Rehearing)

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

32363, 32364-5

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 4th day of March, one thousand nine hundred and sixty-nine.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SARA NICOLL GOTTHELF,

Respondent.

THEODORE J. GOTTHELF and TOBY GOTTHELF,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

(and another case).

It is hereby ordered that the motion by counsel for the petitioner for leave to file a petition for rehearing on or before February 27, 1969, having been granted, it is further ordered that the time is hereby extended to Friday, March 7, 1969.

LEONARD P. MOORE
Leonard P. Moore, *USCJ*

DUDLEY D. BONSAL
Dudley D. Bonsal, *USDJ*

March 4, 1969

APPENDIX F

(Order Denying Petition for Rehearing)

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

32363-5

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SARA NICOLL GOTTHELF,

Respondent.

THEODORE J. GOTTHELF and TOBY GOTTHELF,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

(and another case).

A petition for a rehearing having been filed herein by counsel for petitioners Theodore J. Gotthelf and Toby Gotthelf.

Upon consideration thereof, it is Ordered that said petition be and it hereby is

DENIED.

/s/ STERRY R. WATERMAN
Sterry R. Waterman, *USCJ*

/s/ LEONARD P. MOORE
Leonard P. Moore, *USCJ*

/s/ DUDLEY B. BONSAL
Dudley B. Bonsal, *USDJ*

March 13, 1969

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FILED
JUN 27 1969
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1969.

No. 294

SOUTHEASTERN CANTEEN CO.,
CANTEEN SERVICE CO. OF TOLEDO,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit.

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In the Supreme Court of the United States

OCTOBER TERM, 1969.

No. _____.

SOUTHEASTERN CANTEEN CO.,
CANTEEN SERVICE CO. OF TOLEDO,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals For the Sixth Circuit.

Petitioners, Southeastern Canteen Co. and Canteen Service Co. of Toledo, petition that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Sixth Circuit denying in part Petitioner Southeastern Canteen Co.'s petition for review and affirming in part a decision of the Tax Court of the United States and to review a judgment of the United States Court of Appeals for the Sixth Circuit denying Petitioner Canteen Service Co. of Toledo's petition for review and affirming a decision of the Tax Court of the United States.

OPINIONS BELOW.

The opinion of the Court of Appeals (Appendix A), has not yet been reported officially.* The Decisions and Memorandum Findings of Fact and Opinion of the Tax Court of the United States (Appendix B) are reported at 36 P-H Tax Ct. Mem. 973 (1967).

* For convenience the appendix has been printed and bound separately.

JURISDICTION.

The opinion of the Court of Appeals for the Sixth Circuit was entered on May 13, 1969. On May 23, 1969, Petitioners filed a Motion to Stay the Mandate of the Court of Appeals and an Order of the Court of Appeals for the Sixth Circuit was entered on June 2, 1969 staying the issuance of the mandate for thirty days from June 2, 1969, pending the filing of a petition for writ of certiorari. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED.

1. Can the Court of Appeals, first conclude with the trial court that a single ultimate fact is determinative of the issues, then find the essential supporting evidentiary facts directly contrary to corresponding facts found by the trial court, and, at the same time, decide that the ultimate finding of the trial court is *not* clearly erroneous?

2. Whether the Federal Income Tax may be collected twice on the same income?

3. Whether decisions reallocating income between members of a family or between stockholders and their controlled corporation may be applied to disallow deductions for payments required to be made by a taxpayer to an unrelated and adverse party?

4. What is arm's length bargaining?

STATUTE INVOLVED.

The relevant provisions of the Internal Revenue Code of 1954, as amended, are set forth in Appendix C.

STATEMENT OF THE CASE.

In this case, the Court of Appeals for the Sixth Circuit affirmed in part the Decisions and Memorandum Findings of Fact and Opinion of the Tax Court of the United States. The Tax Court had disallowed the surtax exemption of Petitioner, Southeastern Canteen Co. for its taxable years ended October 3, 1959, October 1, 1960 and September 30, 1961. The Court of Appeals reversed and vacated the judgment of the Tax Court disallowing Petitioner, Southeastern Canteen Company's surtax exemption.

Petitioners are here requesting a review of the affirmance by the Court of Appeals of the Tax Court's judgment disallowing the deduction pursuant to Section 162(a)(3) of the Internal Revenue Code of 1954, of certain rentals and certain location commissions paid by the Petitioners.

A. THE FACTS.

1. The Organization and Operation of Canteen Service Co. of Toledo and Southeastern Canteen Co.

Canteen Service Co. of Toledo (hereinafter referred to as "Canteen Service"), was incorporated under the Laws of Ohio on March 16, 1946 with offices in Toledo, Ohio (27a).[1] On March 16, 1946 Canteen Service issued 1,000 of its common shares to Ben T. Handwork in exchange for, among other things, a franchise granted by Automatic Canteen Company of America (hereinafter referred to as "Automatic") for the sale of candy, gum, nuts and other articles through automatic vending machines (32a). On July 6, 1947 Ben T. Handwork entered into a

[1] References, unless otherwise indicated, are to the Appendix of the Petitioners in the Court of Appeals.

new Franchise and Distributor's Lease Agreement with Automatic which provided for the sale of food and beverages through vending machines (hereinafter sometimes called "canteens") in certain counties of Northwestern Ohio. On July 6, 1947 Ben T. Handwork, with the consent of Automatic, assigned that Franchise and Distributor's Lease Agreement to Canteen Service and Canteen Service operated under that Agreement during its fiscal year ended September 30, 1961 (97a).

During the fiscal year ended September 30, 1961 all of the 750 outstanding common shares of Canteen Service were held and owned by Virgil A. Gladieux of Toledo, Ohio (28a, 55a). During the fiscal year ended September 30, 1961, Canteen Service maintained its books and records under the accrual system of accounting and it employed the thirteen (13) period system of tabulating its income and expenses, each such period consisting of four (4) weeks (28a). Canteen Service duly filed its Federal Income Tax Return for the fiscal year ended September 30, 1961 with the District Director of Internal Revenue in Cleveland, Ohio (Exhibit A).

Southeastern Canteen Co. (hereinafter referred to as "Southeastern") was incorporated on January 19, 1956, under the laws of the State of Michigan, with a registered office in Detroit, Michigan with operating offices in Monroe, Michigan and in Adrian, Michigan, and with offices of its officers in Toledo, Ohio (28a, 76a). Subsequent to the incorporation of Southeastern, its outstanding capital stock consisted of twenty common shares of which Virgil A. Gladieux owned fifteen and Ben T. Handwork owned five. On July 21, 1959, Southeastern redeemed the five common shares then owned by Ben T. Handwork and thereafter the entire outstanding common shares of South-

eastern, consisting of fifteen common shares, were held and owned by Virgil A. Gladieux (29a, 55a).

During the fiscal year ended September 30, 1961, Southeastern sold food and beverages through vending machines in two counties in Southeastern Michigan, those counties being those originally designated under the provisions of a certain Franchise and Distributor's Lease Agreement entered into by and between Automatic and Ben T. Handwork on January 20, 1956, and assigned to Southeastern on January 20, 1956, by Ben T. Handwork with the consent of Automatic (28a, 29a).

2. Background of the Canteen Service Co. of Toledo and Southeastern Canteen Co. Relationships with the Gladieux Corporation.

Gladieux Corporation was incorporated under the laws of the State of Ohio on July 16, 1931, under the name of Buddies Box Lunch, Inc. On September 18, 1944 its corporate name was changed to Buddies Lunch System, Inc. On August 3, 1955 its corporate name was changed to Buddies Food Services, Inc. and on November 2, 1960 its corporate name was changed to Gladieux Corporation (29a, 30a).

Prior to May 10, 1946, Gladieux Corporation (then known as Buddies Lunch System, Inc.) was principally engaged in the business of operating cafeterias and lunch counters and dispensing food in several manufacturing plants in the City of Toledo and vicinity, and it also sold candy, gum and nuts both over its counters and through vending machines at its food service locations, as well as at gas stations and other locations (37a).

On May 10, 1946, the outstanding capital stock of Gladieux Corporation was owned fifty per cent (50%)

by Virgil A. Gladieux and fifty per cent (50%) by Nelson Gladieux, brother of Virgil A. Gladieux. On May 25, 1955, Virgil A. Gladieux became the sole stockholder of the Gladieux Corporation (37a). On May 10, 1946 Ben T. Handwork was the sole stockholder of Canteen Service Co. of Toledo (37a).

On May 10, 1946 Gladieux Corporation (then known as Buddies Lunch System, Inc.) entered into an Agreement with Canteen Service whereby Gladieux Corporation transferred to Canteen Service its vending machine business (37a, 38a, 179a-191a). Under the terms of this Agreement of May 10, 1946, among other things, it was agreed that Canteen Service would pay to Gladieux Corporation location commissions of twelve per cent (12%) on all gross sales of candy, gum and nuts sold through vending machines at all locations where the Gladieux Corporation then, or thereafter, operated cafeterias, lunch counters or other food dispensing facilities for the full term of the Agreement and any extension or renewal thereof. The term of the Agreement was for five (5) years and thereafter until any party gave three (3) months' termination notice in writing to the other (179a-191a).

The sale of the Gladieux vending business to Canteen Service appealed strongly to Virgil A. Gladieux for financial reasons, since, under the Automatic franchise arrangement under which Canteen Service was then operating, it, Canteen Service, could lease its vending equipment from Automatic, whereas up to that time the Gladieux interests were compelled to purchase their vending equipment thus limiting their financial resources for any expansion program (56a).

After May 10, 1946, as other type vending machines became available, Canteen Service commenced to vend other products through the machines, such as milk, coffee,

ice cream and hot food, thus necessitating, for business reasons, adjustments to the rates of location commissions payable to the Gladieux interests by Canteen Service under the Agreement of May 10, 1946. The expansion of the vended food line resulted in an inconsistent pattern of location commissions payable to the Gladieux interests by Canteen Service under the Agreement of May 10, 1946. Up and until the latter part of the year 1960 the location commissions paid varied with respect to products and with respect to locations (56a, 57a, 58a).

From and after May 10, 1946 Canteen Service, pursuant to paragraph 4 of its Agreement with the Gladieux Corporation (then known as Buddies Lunch System, Inc.) dated May 10, 1946 (179a-191a), paid a location commission to the Gladieux interests of twelve per cent (12%) on sales made by Canteen Service through vending machines located at the facilities of the Libbey-Owens-Ford Glass Company (hereinafter referred to as "L.O.F."), since the Gladieux interests prior to and after May 10, 1946 were conducting an in-plant feeding activity at the facilities of L.O.F. and prior to May 10, 1946 the Gladieux interests had vending machines operating on the premises of L.O.F. In 1958, for good business reasons, the Gladieux interests temporarily waived the location commissions payable to them on the L.O.F. business. The location commissions of L.O.F. business were reinstated by the Gladieux Corporation as of September 30, 1960 (69a, 70a, 71a, 72a, 73a, 179a-191a, 207a-209a).

On or about December 4, 1953, Gladieux Corporation (then known as Buddies Lunch System, Inc.) commenced the operation of a restaurant and a cafeteria at the plant and facilities of the Toledo Scale Company and continued operations throughout the taxable year of Canteen Service which is involved in these proceedings. At or about the

same date, Canteen Service was permitted to install canteens at nine (9) different locations throughout the plants of the Toledo Scale Company. For good business reasons, the Gladieux interests temporarily waived a part of these location commissions and, as of September 30, 1960, these location commissions were reinstated (38a, 72a, 73a).

3. Petitioners' Relationships With ABC Vending Corporation.

a. Background.

On June 30, 1960 Virgil A. Gladieux and his wife, Beatrice G. Gladieux, held and owned all the outstanding capital stock of fifteen (15) corporations engaged in the merchandising and vending of food, beverages, cigarettes and gum in various areas of the United States. Included among these fifteen (15) corporations on June 30, 1960 were Canteen Service, Southeastern and the Gladieux Corporation (then named Buddies Food Services, Inc.) (30a).

Gladieux Corporation during the taxable year here involved operated various food systems, such as in-plant employee feeding for industrial concerns, operation of cafeterias, snack bars and dining rooms, and route sales of food and beverages from mobile vehicles (30a, 57a, 70a). The books and records of the Gladieux Corporation were maintained on the accrual system of accounting and on a calendar year basis (30a). During the years and periods here involved, and until February 2, 1961, all the outstanding capital stock of the Gladieux Corporation consisting of five hundred (500) common shares, without par value, was held and owned of record, but subject to the Agreement of June 30, 1960, as follows:

Virgil A. Gladieux	499 shares
Beatrice G. Gladieux (wife of Virgil A. Gladieux)	1 share

(30a, 150a-161a).

ABC Vending Corporation, a Delaware corporation (hereinafter referred to as "ABC"), immediately prior to June 30, 1960, was primarily engaged in the food and beverage vending and merchandising business with book net worth in excess of sixteen million dollars ($16,000,000) and with an annual vending volume in excess of sixty million dollars ($60,000,000). It was a publicly-owned corporation, its stock being listed on the New York Stock Exchange. In January of 1961, it had eight thousand five hundred and twenty-two (8,522) shareholders who owned one million two hundred twenty-eight thousand three hundred and twenty-eight (1,228,328) shares of common stock, including forty-eight thousand nine hundred and sixty (48,960) treasury shares. Prior to February 2, 1961, neither Virgil A. Gladieux nor Beatrice G. Gladieux owned any capital stock of ABC (30a, 31a).

b. The Agreement of June 30, 1960.

On June 30, 1960, ABC and Virgil A. Gladieux entered into an Agreement whereby Virgil A. Gladieux, among other things, agreed to transfer to ABC all of the outstanding capital stock of the fifteen corporations owned by him and his wife [including the outstanding capital stock of Canteen Service, Southeastern and Buddies Food Services, Inc. (name changed to Gladieux Corporation on November 2, 1960)] in exchange for eighty thousand (80,000) shares of the common capital stock of ABC. Pursuant to Article Fourth of this Agreement, it was contemplated that the closing date for the exchange of stock

would occur approximately ninety days after June 30, 1960, or on or about September 30, 1960 (31a, 67a, 68a).

c. Amendments to the Agreement of June 30, 1960.

Automatic refused to consent to the sale and transfer to ABC by Virgil A. Gladieux of the outstanding capital stock of Canteen Service and of Southeastern, relying on the provisions of Section 25 of its Franchise and Distributor's Lease and Agreement with Canteen Service (97a, 111a, 112a) and its similar Agreement with Southeastern (123a, 138a, 139a). Automatic's refusal was submitted to arbitration. On December 27, 1960 the arbitrators decided that Automatic's withholding of consent was not unreasonable, arbitrary or capricious (31a, 162a, 163a).

Prior to the decision of the arbitrators, ABC's representatives and Virgil A. Gladieux conducted negotiations to determine what course of action would be undertaken with respect to the exchange of stock contemplated by the Agreement of June 30, 1960 in the event that the arbitrators decided that the shares owned by Virgil A. Gladieux in the Petitioners could not be transferred to ABC (63a, 64a). Virgil A. Gladieux was not motivated in his thinking with respect to the possible rearrangement of the Agreement of June 30, 1960 by any avoidance or evasion of Federal Income Tax liability (69a, 70a), but rather was negotiating on behalf of the Petitioners with a desire to get the best possible arrangement for them from ABC. In the course of those negotiations, Virgil A. Gladieux was concerned particularly with respect to the following possibilities:

(1) If Canteen Service and Southeastern were to be omitted from the deal with ABC and if Virgil A. Gladieux was to be left with the ownership of those two corporations, he wanted to maintain a close relationship between

those corporations and the other Gladieux corporations, which would be then owned by ABC, since those other Gladieux corporations, through their food service arrangements in industry, controlled more than seventy-five per cent (75%) of the vending business operated by Canteen Service and Southeastern, and he wanted to be certain that Canteen Service and Southeastern would be assured of the continuity of the volume of their business (64a).

(2) He wanted to work out any rearrangement with ABC in such a way that Canteen Service and Southeastern would be assured of financial aid from ABC to assist them in the expansion of their facilities and in the acquisition of other vending businesses in their territories (64a).

(3) He desired that Canteen Service and Southeastern be assured against any operating losses (64a).

(4) He desired that the rates of location commissions being paid by Canteen Service and by Southeastern to the other Gladieux corporations, which were not uniform, be standardized so as to eliminate future controversies with respect to them and any claim of conflict of interest on his part, since ABC contemplated that Virgil A. Gladieux would continue as an officer of Gladieux Corporation and become an officer of ABC (65a, 66a).

(5) While he had the notion that during these negotiations the representatives of ABC had in mind a rearrangement which would enable ABC to take most of the profits of Canteen Service and Southeastern, he was of the opinion that the transaction could be rearranged so as to generate profits in those two companies (66a) by having ABC supply all of the operating equipment, thus eliminating rentals to Automatic, and by having ABC provide funds for the acquisition by Canteen Service and Southeastern of other vending companies in the territories with

the result that no rentals on such purchased equipment would be payable to Automatic (66a).

(6) During the period of those negotiations, he, Virgil A. Gladieux, was contemplating the acquisition by Canteen Service of certain other vending companies (66a, 67a).

During the negotiations, which took place before and after the decision of the arbitrators, by and between Virgil A. Gladieux for Canteen Service and Southeastern and representatives of ABC, it was agreed that the closing date for the transactions having to do with Canteen Service and Southeastern should be as of September 30, 1960, since that was the approximate closing date contemplated by the original Agreement of June 30, 1960 (150a-162a, 67a).

Renegotiation of the original Agreement culminated in the following Agreements being entered into on the dates indicated:

(1) A Supplemental Agreement between Virgil A. Gladieux and ABC dated January 26, 1961 which, among other things, eliminated the requirement that the shares of Canteen Service and Southeastern be transferred to ABC and reduced the number of shares of ABC stock to be transferred to Virgil A. Gladieux from 80,000 to 68,500 (31a, 32a, 164a, 165a);

(2) An Agreement between Virgil A. Gladieux, ABC, Canteen Service, Southeastern and Gladieux Corporation (formerly Buddies Food Services, Inc.) dated January 26, 1961 which, among other things, required Canteen Service and Gladieux Corporation, before closing, to enter into an Agreement for the sale of certain of the operating assets of Canteen Service to Gladieux Corporation, for the leasing of those assets by Gladieux Corporation to Canteen Service, the form and terms of this sale agreement and

of this lease being attached to the Agreement as an exhibit; required Southeastern and Gladieux Corporation, before closing, to enter into an Agreement for the sale of certain of the operating assets of Southeastern to Gladieux Corporation, for the leasing of those assets by Gladieux Corporation to Southeastern, the form and terms of this sale agreement and of this lease being attached to the Agreement as an exhibit, and *ABC agreed to cause Gladieux Corporation* to pay Canteen Service and Southeastern the considerations referred to in the Agreement (32a, 165a-168a);

(3) An Agreement between Canteen Service and Gladieux Corporation (formerly Buddies Food Services, Inc.) dated January 31, 1961 which, among other things, provided for the sale and transfer by Canteen Service to Gladieux Corporation of certain land, buildings, improvements, trucks, machinery, equipment, furniture and fixtures and vending machines for $184,659.83, that being the net book value thereof as of October 1, 1960; further provided for the lease by Gladieux Corporation to Canteen Service of the assets so purchased for a term of twenty (20) years from October 1, 1960, with certain renewal options, Gladieux Corporation further obligating itself to provide and lease to Canteen Service all additional equipment required by Canteen Service in the operation of its vending business. The rental under the lease was ten per cent (10%) of the gross sales of Canteen Service on and after October 1, 1960, with the limitation that if this rent resulted in an operating loss to Canteen Service, the amount of the rent for the fiscal period of the loss would be reduced by the amount of the loss. Net operating income was to be determined before federal income taxes and before certain other deductions. This Agreement also provided for the payment by Canteen Service to Gladieux

Corporation, from and after October 1, 1960, of location commissions on all sales at vending locations at any time derived through Gladieux Corporation, or any corporation affiliated with Gladieux Corporation, or through Virgil A. Gladieux, at uniform rates as set forth in a schedule attached to the Agreement (32a, 169a-174a);

(4) An Agreement between Southeastern and Gladieux Corporation (formerly Buddies Food Services, Inc.) dated January 31, 1961 which, among other things, provided for the sale and transfer by Southeastern to Gladieux Corporation of certain trucks, furniture and fixtures and vending machines for $5,109.43, that being the net book value thereof as of October 1, 1960; further provided for the lease by Gladieux Corporation to Southeastern of the assets so purchased on the same terms as the lease between Canteen Service and Gladieux Corporation described above at (3). This Agreement also further provided for the payment by Southeastern to Gladieux Corporation from and after October 1, 1960 of location commissions on all sales at vending locations at any time derived through Gladieux Corporation, or any corporation affiliated with Gladieux Corporation, or through Virgil A. Gladieux, at uniform rates as set forth in a schedule attached to the Agreement (32a, 34a, 175a-179a).

d. Consummation of the Agreement of June 30, 1960, as Amended.

Legal title to the assets sold, transferred and assigned to Gladieux Corporation by Canteen Service and Southeastern, respectively, according to the Agreements of January 31, 1961, was conveyed to the Gladieux Corporation by the selling corporations as and when required by the Agreements (73a, 74a, 169a-174a, 175a-179a, 209a-211a),

and payment therefor was received by Canteen Service and Southeastern (32a-34a).

On February 2, 1961 ABC delivered to Virgil A. Gladieux fifty-four thousand and two hundred (54,200) shares of its common capital stock and to Beatrice G. Gladieux fourteen thousand and three hundred (14,300) shares of its common capital stock. On February 2, 1961 Virgil A. Gladieux and Beatrice G. Gladieux transferred to ABC the outstanding shares of the thirteen (13) corporations heretofore referred to as being wholly owned by them, being those corporations referred to in the Agreement dated June 30, 1960 (150a-162a), excepting Canteen Service and Southeastern, but including Gladieux Corporation (formerly Buddies Food Services, Inc.) (35a, 36a).

During the fiscal year ended September 30, 1961, Canteen Service paid to or accrued in favor of Gladieux Corporation as rentals the sum of one hundred and twenty-one thousand one hundred and seventy-two dollars and fifteen cents ($121,172.15), pursuant to the Agreements entered into in January of 1961 by and between ABC, Virgil A. Gladieux, Canteen Service, Southeastern and Gladieux Corporation (165a-179a), and deducted that amount as rental from its gross income on its books and for federal income tax purposes (36a, 213a, Exhibit A). During the calendar years 1960 and 1961, Gladieux Corporation included in its taxable income for federal income tax purposes the amount paid to it or accrued as a liability in its favor as rental by Canteen Service during Canteen Service's year ended September 30, 1961 (36a).

During the fiscal year ended September 30, 1961, Southeastern paid to or accrued in favor of Gladieux Corporation as rentals the sum of twelve thousand two hundred and eleven dollars and thirty cents ($12,211.30),

pursuant to the Agreements entered in in January of 1961 by and between ABC, Virgil A. Gladieux, Canteen Service, Southeastern and Gladieux Corporation (165a-179a) and deducted that amount as rentals from its gross income on its books and for federal income tax purposes for that fiscal year (36a, 37a, 214a, Exhibit B), and Gladieux Corporation included in its taxable income for federal income tax purposes the amount so paid to it or accrued as a liability in its favor by Southeastern during its fiscal year ended September 30, 1961 (36a, 37a).

Pursuant to the provisions of the said agreements executed in January of 1961 (165a-179a), all location commissions payable thereunder were standardized at the rates set forth in Schedule II appended to said Agreements (42a).

(e) The Economic Realities of ABC's Relationship with the Petitioners.

The Petitioners' relationship with ABC was through the Gladieux Corporation, which was ABC's wholly owned subsidiary for equitable purposes on and after September 30, 1960 and formally so on and after February 2, 1961 (31a, 35a, 36a, 150a-162a).

Virgil A. Gladieux felt that the Petitioners would be able to operate profitably under the arrangement that he negotiated for them with ABC (66a, 67a). In the event that from and after September 30, 1960 and until October 2, 1965, Gladieux Corporation, under Section 4 of the Agreement of January 31, 1961 (175a-179a) had purchased the canteens which were rented to Southeastern by Automatic, the resulting operating income to Southeastern before dividend income and before federal income tax would have been as follows:

Fiscal Year ended September 30, 1961	$ 4,773.13
Fiscal Year ended September 29, 1962	8,239.48
Fiscal Year ended September 28, 1963	13,621.41
Fiscal Year ended October 3, 1964	12,298.26
Fiscal Year ended October 2, 1965	18,331.65

(218a.)

If the Gladieux Corporation, under Section 4 of the Agreement of January 31, 1961 (169a-174a), had purchased the canteens which were rented to Canteen Service by Automatic, the resulting operating income to Canteen Service, before dividend income and before federal income tax during the same period would have been, as follows:

Fiscal Year ended September 30, 1961	$80,551.87
Fiscal Year ended September 29, 1962	36,599.54
Fiscal Year ended September 28, 1963	-0-
Fiscal Year ended October 3, 1964	-0-
Fiscal Year ended October 2, 1965	17,360.87

(217a.)

The adverse results reflected for the fiscal years ended September 28, 1963 and October 3, 1964 are attributable to the unprofitable on-street cigarette vending businesses acquired from Rex Vending Machines and Swan Sales Company in 1963 and sold in 1964 (68a, 69a).

At the time of the Tax Court hearing, Virgil A. Gladieux had in mind additional acquisitions by Canteen Service of vending businesses, but they had been deferred in order to permit Gladieux Corporation to recover from the cash requirements of the two acquisitions in 1963 (69a) which it had financed for Canteen Service. Upon acquisition of those vending businesses no rental would be payable to Automatic on the canteens involved, since the canteens would be purchased by Gladieux Corporation under the provisions of Section 4 of the Agreements of January 31, 1961 (66a, 67a, 169a-179a).

Virgil A. Gladieux also had in mind the eventual purchase by Gladieux Corporation of the canteens being

rented from Automatic by Canteen Service and Southeastern, thus eliminating the rental expense being paid to Automatic by Canteen Service and Southeastern. Any such purchase would require a substantial amount of money (67a, 69a).

In accordance with the provisions of Section 4 of the Agreements entered into on January 31, 1961, by and between Gladieux Corporation and the Petitioners (169a-179a), Gladieux Corporation expended the following amounts (or incurred liability therefor) during the periods indicated for the purchase of operating assets for lease to the Petitioners:

	Canteen Service	Southeastern
For the period Oct. 1, 1960 to Dec. 24, 1960	$ 5,569.85	$ 2,633.64
For the period Dec. 24, 1960 to Dec. 23, 1961	15,683.25	-0-
For the period Dec. 23, 1961 to Dec. 22, 1962	45,284.08	2,385.83
For the period Dec. 22, 1962 to Dec. 21, 1963	475,824.74	4,064.93
For the period Dec. 21, 1963 to Dec. 26, 1964	53,229.20	3,013.51
Totals	$595,591.12	$12,097.91

(212a.)

From October 1, 1960 to December 26, 1964, the cash flow received by Gladieux Corporation for rentals from Canteen Service and Southeastern under the leases included in the Agreements of January 31, 1961 (169a-179a) amounted to four hundred and nineteen thousand and five dollars and eighty-one cents ($419,005.81). The cash outlay for assets purchased by Gladieux Corporation which were leased to Canteen Service and to Southeastern by the Gladieux Corporation under Section 4 of the Agreements (169a-179a) for this period (October 1, 1960 to December 26, 1964) amounted to five hundred and eighty thousand three hundred and four dollars and fifty-one cents ($580,304.51). The resulting net cash to Gladieux Corporation at the end of the period (December 26, 1964)

amounted to a *deficiency* of one hundred sixty-one thousand two hundred ninety-eight dollars and seventy cents ($161,298.70) (215a).

B. THE COURT OF APPEALS AND THE TAX COURT'S TREATMENT OF THE AGREEMENT OF JUNE 30, 1960, AS AMENDED BY THE AGREEMENTS OF JANUARY, 1961.

The Respondent issued his Notices of Deficiency on June 19, 1964. Pursuant to Sections 6213 and 7442 of the Internal Revenue Code of 1954 (26 U. S. C. 6213, 7442) the Petitioners filed their Petitions with the Tax Court of the United States on September 3, 1964.

1. Rentals Paid to the Gladieux Corporation.

The Court of Appeals and the Tax Court allowed Canteen Service as a rental deduction for the fiscal year ended September 30, 1961, the amount of fifty-three thousand five hundred and ninety-two dollars and seventy-nine cents ($53,592.79) (36a), which was the amount of the total depreciation, on a straight line method with various lives, charged off and deducted as an expense by Canteen Service for the fiscal year ended October 1, 1960, on the buildings, improvements, trucks, machinery, equipment, furniture and fixtures and vending machines sold by Canteen Service to Gladieux Corporation (35a) pursuant to said Agreements (165a-179a), thus disallowing as a deduction from the taxable income of Canteen Service sixty-seven thousand five hundred and seventy-nine dollars and thirty-six cents ($67,579.36) of the rentals so paid or accrued (36a, 245a).

The Court of Appeals and the Tax Court allowed Southeastern as a rental deduction for the fiscal year ended September 30, 1961, the amount of one thousand

nine hundred and six dollars and fifty-nine cents ($1,906.59) (36a, 37a), that being the amount of total depreciation, on a straight line method with various lives, charged off and deducted as an expense by Southeastern for the fiscal year ended October 1, 1960, on the trucks, furniture and fixtures and vending machines assigned by Southeastern to Gladieux Corporation (35a) pursuant to said agreements (165a-179a), thus disallowing as a deduction from the taxable income of Southeastern ten thousand three hundred and four dollars and seventy-one cents ($10,304.71) of the rentals so paid or accrued (36a, 37a, 245a).

2. Location Commissions Paid by Canteen Service.

The Court of Appeals and the Tax Court disallowed to Canteen Service, as a deduction for the fiscal year ended September 30, 1961, all location commissions paid to or accrued in favor of Gladieux Corporation with respect to sales by Canteen Service at L.O.F. and Toledo Scale Company even though these location commissions were paid or accrued for that fiscal year at the uniform rates prescribed by contract (165a-179a).

The Court of Appeals and the Tax Court disallowed to Canteen Service, as a deduction for the fiscal year ended September 30, 1961, location commissions payable to or accrued in favor of Gladieux Corporation by Canteen Service on other business (other than on L.O.F. and Toledo Scale Company business) in the amount of the excess of the commissions at the rates prescribed by contract (165a-179a) and as set forth in the schedule attached thereto over the commissions at the rates in effect prior to October 1, 1960 for the period beginning October 1, 1960 and ending February 20, 1961.

In summary, The Court of Appeals and the Tax

Court's treatment of location commissions which were paid to or accrued in favor of Gladieux Corporation by Canteen Service for the fiscal year ended September 30, 1961 under the Agreement (165a-179a) was as follows:

	Allowed as Deduction	Disallowed as Deduction
On L.O.F. business	–0–	$60,109.11
On Toledo Scale Company business	–0–	9,320.05
On other business for the three periods ending December 24, 1960	$13,541.09	3,043.45
On other business for the two periods ending February 20, 1961	7,799.03	1,615.65
On other business for the eight periods ending September 30, 1961 at the revised rates fixed by the Agreement of January 31, 1961	39,492.30	–0–
Totals	$60,832.42	$74,088.26

(38a-41a, 250a.)

The location commissions paid or accrued by Canteen Service for the fiscal year ended September 30, 1961, and which have been disallowed as a deduction from the gross income of Canteen Service for Federal Income Tax purposes, to-wit, $74,088.26, were included in the taxable income of the following corporations in the amounts and for the taxable years as follows:

Included by Gladieux Corporation in its 1960 Federal Income Tax Return	$24,286.68
Included by Gladieux Corporation in its 1961 Federal Income Tax Return	44,213.28
Included by Buddies of Lucas County, Inc. (one of the Gladieux companies acquired by ABC) in its 1961 Federal Income Tax Return	5,588.30
Total	$74,088.26

(43a, 44a.)

3. Location Commissions paid by Southeastern.

The Court of Appeals and the Tax Court for the fiscal year ended September 30, 1961, in effect have disallowed as a deduction from the gross income of Southeastern location commissions as follows:

The excess of location commissions computed at the rates fixed by the Agreement of January 31, 1961 for the three accounting periods ending on December 24, 1960 over said commissions computed for said accounting periods at the rates in effect prior to October 1, 1960	$ 995.63
The excess of location commissions computed at the rates fixed by the Agreement of January 31, 1961 for the two accounting periods ending on February 20, 1961 over said commissions computed for said accounting periods at the rates in effect prior to October 1, 1960	598.21
Local commissions disallowed	$1,593.84
	(42a, 43a, 250a.)

thereby, in effect, allowing as a deduction from the gross income of Southeastern location commissions as follows:

Location commissions subject to the Agreement of January 31, 1961 for the three accounting periods ending December 24, 1960 at the prior rates in effect	$1,138.63
Location commissions for the accounting periods ending on February 20, 1961 at the prior rates in effect	825.89
Location commissions for the eight accounting periods ending on September 30, 1961 at the rates as revised by said Agreement of January 31, 1961	5,616.21
All other location commissions for the fiscal year ended September 30, 1961 in the amounts as paid	2,046.81
Location commissions allowed	$9,627.54
	(43a.)

The location commissions paid or accrued by Southeastern for the fiscal year ended September 30, 1961, and which were disallowed as a deduction from the gross income of Southeastern for Federal Income Tax purposes, to-wit, $1,593.84, were included in the taxable income of Gladieux Corporation in its Federal Income Tax Returns as follows:

For the year 1960	$ 995.63
For the year 1961	598.21
Total	$1,593.84
	(44a.)

REASONS FOR GRANTING THE WRIT.

1. The Court of Appeals and the Tax Court both stated that the ultimate factual question before them was whether the agreements of January, 1961 between ABC, Canteen Service, Southeastern, Gladieux Corporation and Virgil A. Gladieux were the result of arms length bargaining. (Appendices A, B, pp. 7 and 40). Both Courts also held, therefore, that if those agreements of January, 1961 were the result of arms length bargaining the payments required to be made by Canteen Service and Southeastern under those agreements, and actually made to and received by Gladieux Corporation, after it had been acquired by ABC, were deductible payments under Section 162(a)(3) of the Internal Revenue Code of 1954.

In order to determine the ultimate factual question it was necessary for the Courts below to determine the ownership of the corporate parties to the bargaining. The parties to the January, 1961 agreements in question were ABC, Canteen Service, Southeastern, Gladieux Corporation and Virgil A. Gladieux. (165a-179a).

ABC was throughout the period in controversy a publicly held corporation listed on the New York Stock Exchange. (30a, 31a). At no time during or prior to January of 1961 did Virgil A. Gladieux or his wife own any stock in ABC. (30a, 31a).

Virgil A. Gladieux, throughout the period in controversy, has owned all of the outstanding stock of Petitioners, Canteen Service and Southeastern. (28a, 29a, 55a).

The Tax Court held that:

> "* * * during the entire negotiations leading up to the execution of the sale-leaseback agreements, the owner of both the lessor (Gladco) [1] and the lessees

[1] The Tax Court referred throughout its opinion to the Gladieux Corporation as Gladco.

(petitioners) was the same person, Virgil Gladieux. Petitioners' attempt to transform such an identity of interest into a relationship which petitioners characterize as adverse, transgresses reasonable imagination." (Appendix B, p. 43.)

The Court of Appeals apparently transgressed reasonable imagination because it found that the Gladieux Corporation in January of 1961 was owned by ABC and therefore that the "identity of interest" found by the Tax Court was not present. (Appendix A, p. 4.)

Petitioners have maintained throughout this dispute that Virgil Gladieux negotiated the agreements in question on behalf of the Petitioners with ABC which was negotiating on behalf of itself and the Gladieux Corporation and therefore that those agreements were the result of arms length bargaining. Certainly the determination of which party to the bargaining owned the Gladieux Corporation during the bargaining and at the time the agreements were executed is essential to determination of whether the agreements were the result of arms length bargaining.

Although the Court of Appeals found contrary to the Tax Court's finding of fact on the essential question of who owned the Gladieux Corporation the Appellate Court came to the inconsistent conclusion that the Tax Court's findings were not clearly erroneous.

The Court of Appeals by finding the adverse relationship existed between the parties to the bargaining could not logically and reasonably find the conclusions of the Tax Court not to be clearly erroneous.

This internal inconsistency between the reviewing and trial court on the finding of the essential fact is a radical departure from the accepted and usual course of judicial proceedings.

2. All rentals and location commissions paid by Canteen Service and Southeastern under the agreements of January, 1961 have been included in the gross income of the recipient for Federal Income Tax purposes. (36a, 37a, 43a, 44a). Petitioners were required to pay and continue to be required to pay these rentals and location commissions.

It must be perfectly obvious that Petitioners cannot economically pay to ABC rentals and location commissions and at the same time pay income taxes on those amounts so paid and survive for any great length of time. For example, in the year here involved Canteen Service paid out One Hundred Twelve Thousand Seven Hundred Sixty-nine Dollars and Seventeen Cents ($112,769.17) in rentals and location commissions which were disallowed as deductions by Respondent who now is requiring a further payment of income taxes of Fifty-eight Thousand Eight Hundred Sixty-three Dollars and Seventy-three Cents ($58,863.73), on the One Hundred Twelve Thousand Seven Hundred Sixty-nine Dollars and Sixty-seven Cents ($112,769.67) which has irretrievably been expensed pursuant to contractual obligations. Canteen Service had a book net worth as of September 30, 1961 of Three Hundred Seventy-four Thousand Six Hundred Three Dollars and Seventy-five Cents ($374,603.75), and it would, therefore, appear that at the same rate per annum Canteen Service would be economically destroyed within approximately six and one-half (6½) years of this long term contract. (19a, Resp.'s Exh. A.)

> "We start with the proposition that the federal income tax is a tax on net income, * * *." *Commissioner v. Tellier*, 383 U.S. 687, 691 (1966).

In *Tellier, supra*, this Court expressed a positive antipathy to taxing gross income rather than net income.

The Internal Revenue Code and Respondent's Regulations and rulings contain a definite expression of policy against the double taxation of income where related parties are involved. § 1311 to 1314 of the Internal Revenue Code of 1954; Treas. Regs. 1.482-1(d)(2)(1962); Rev. Proc. 65-17, 1965-1 Cum. Bull. 833; and Rev. Proc. 64-54, 1964-2 Cum. Bull. 1008. Certainly no harsher result should ensue to unrelated parties.

Here the payor and recipient are unrelated. The recipient of the rentals and location commissions is not a stockholder of the Petitioners and therefore Petitioners' payments to it cannot be dividends. Since the rental and location commissions were required to be paid to the recipient and were not dividends the amounts of those payments may be subjected to the Federal Income Tax but once. One large bite from the apple by the tax collector should suffice.

3. The Courts below have relied upon *Catherine G. Armston*, 12 T.C. 539, aff'd 188 F.2d 531 (5th Cir. 1951) for the proposition that the Internal Revenue Service is not required to regard a payment as rent because it is so designated and required to be paid (Appendices A, B, pp. 6, 45). In *Armston, supra*, the lessor was the controlling stockholder of the lessee and the courts found that payments to her were dividends rather than rent because she did not, in substance, own the property asserted to have been leased from her. In *Armston, supra*, the courts had no difficulty concluding that Mr. Armston, the other stockholder of the lessee corporation and its principal executive, had devised a scheme to distribute corporate profits to his wife to be reported on her tax return. The Petitioners leased property clearly owned by the lessor. (169a, 175a, 209a-211a). No stockholder Petitioners received the payments at issue. (36a, 37a).

There is a line of authority which applies to this case. In *Skemp v. Commissioner*, 168 F.2d 598, 600 (7th Cir. 1948) reversing 8 T.C. 415 (1947) and *Brown v. Commissioner*, 180 F.2d 926, 929 (3rd Cir. 1950) reversing 12 T.C. 1095 (1949) two Courts of Appeals stated a rule of law under the antecedent provision of Section 162(a)(3) which is clearly contrary to the law adopted by the Court of Appeals in ruling on the Petitioners' appeal.

In *Skemp, supra,* and *Brown, supra,* where the lessee rented property from a trust created by him, the Court of Appeals for both the Seventh and Third Circuits said:

> "There can be no question but what rent required to be paid is properly deductible."

The Petitioners submit that the Supreme Court should resolve the conflict with the Courts of Appeals between the instant decision and *Armston, supra,* on one side, which though factually antithetic were decided on the same stated principles of law, and the decisions in *Skemp, supra,* and *Brown, supra.*

The courts below have misapplied to the Petitioners cases involving intra-family transactions or transactions involving shareholders and their controlled corporations.

The Supreme Court should settle this important question of federal law and prevent this and future misapplication of the law applicable to family and controlled corporate tax avoidance transactions to negotiated transactions between businessmen.

4. The Tax Court concluded that the agreements of January, 1961 between ABC and Gladieux Corporation on one side and Petitioners and Virgil A. Gladieux on the other were not the result of arms length bargaining. The Court of Appeals, misapplying this Court's holding in

Commissioner v. Duberstein, 363 U.S. 278 (1961), found that decision not to be clearly erroneous.

Neither court below even attempted to define the ultimate question of fact in this case; namely what is arms length bargaining. As a matter of information, Petitioners are unable to locate among the myriad of decisions and Regulations applying the criteria of arms length bargaining to taxpayers any authority defining that all important standard.[1]

The Petitioners here urge this Court to define arms length bargaining as it applies to the determination of disputes under Section 162(a)(3) of the Internal Revenue Code so that taxpayers in the future may have some standard to apply to their contractual arrangements and so that future taxpayers will not find themselves in the disastrous predicament facing the Petitioners if the courts below are not reversed.

---

[1] The arms length bargaining standard has often been used, without definition, in other cases, involving Sections 162(a)(3) or its antecedent and 482 of the Internal Revenue Code. For examples see a) for Section 162 cases: *J. J. Kirk, Inc.*, 34 T.C. 130 (1960) aff'd per curiam 289 F.2d 935 (6th Cir. 1961); *Southern Ford Tractor Corporation*, 29 T.C. 833 (1958); *Stanwick's Inc. v. Commissioner*, 15 T.C. 556 (1950), aff'd 190 F.2d 84 (2nd Cir. 1951); *Potter Electric Signal and Manufacturing Co. v. Commissioner*, 29 P-H Tax Ct. Mem. 185 (1960), aff'd 286 F.2d 200 (8th Cir. 1961); b) for Section 482 cases: *Simon J. Murphy v. Commissioner*, 231 F.2d 639, 644-645 (6th Cir. 1955). No discussion of meaning of "arms length"; *Virginia Metal Products*, 33 T.C. 788, 800 (1960) (NA), reversed on other grounds 290 F.2d 675 (3rd Cir, 1961); *Friedlander Corp.*, 25 T.C. 70 (1955) (A); *Polak's Frutal Works, Inc.*, 21 T.C. 1953, 975-976 (1954) (A); *Seminole Flavor Co.*, 4 T.C. 1215, 1232-33 (1945) (A); *Koppers Co.*, 2 T.C. 152 (1943) (A); *Comm'r v. Chelsea Products*, 197 F.2d 620, 623 (3rd Cir. 1952).

CONCLUSION.

For the reasons stated above it is submitted that this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1969.

No. 294

SOUTHEASTERN CANTEEN CO.,
CANTEEN SERVICE CO. OF TOLEDO,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals For the Sixth Circuit.

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APPENDIX TO PETITION FOR WRIT OF CERTIORARI.

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APPENDIX A.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Decided May 13, 1969.)

Before: WEICK, Chief Judge, O'SULLIVAN and PHILLIPS, Circuit Judges.

O'SULLIVAN, Circuit Judge. Petitioners, Southeastern Canteen Co. and Canteen Service Co. of Toledo petition for our review of a decision of the Tax Court, entered September 19, 1967, upholding the Respondent-Commissioner's assessment of deficiencies in income tax in the amounts of $16,589.82 and $58,863.73, respectively. These deficiencies arose primarily from disallowance of parts of deductions from income taken by taxpayer corporations for rent and commissions paid by them to the then owner of the equipment used by taxpayers, and from disallowance of Southeastern Canteen Co.'s claim of corporate exemption from surtax on the first $25,000 of its earnings. Reason for these rulings was provided by a finding that the disallowed rent and commissions paid were not "ordinary and necessary expenses paid or incurred * * * in carrying on" the taxpayers' trade or business, within the meaning of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a). Disallowance of the exemption from surtax of the first $25,000 of Southeastern Canteen Co. earnings, 26 U.S.C. § 11(d), was the product of the Tax Court's finding that Southeastern Canteen Co. was formed by the owners of Canteen Service Co. with the principal purpose of securing the surtax exemption of $25,000 of its earnings, contrary to Section 269 of the Internal Revenue Code of 1954, 26 U.S.C. § 269.

We agree with the Tax Court's affirmance of the Commissioner's disallowance of amounts claimed as rent and other business expenses. We reverse its holding which

denied Southeastern Canteen Co.'s use of the surtax exemption.

The Tax Court decision, filed September 19, 1967, is reported as *Southeastern Canteen Co. and Canteen Service Co. of Toledo v. Comm'r*, 36 P-H Tax Ct. Mem. 973, ¶ 67,183 (1967). The factual history is complicated. Buddies Box Lunch, Inc. was formed as an Ohio corporation on July 16, 1931. The outstanding capital stock was owned fifty percent by Virgil A. Gladieux and fifty percent by his brother, Nelson Gladieux. In 1955, Virgil became sole stockholder and in 1960 the corporate name was changed to Gladieux Corporation (hereinafter Gladco). Gladco was principally engaged in the operation of cafeterias and lunch counters and the dispensing of food in several manufacturing plants in Toledo, Ohio. It also sold candy, gum and nuts both at its lunch counters and through vending machines at locations in and near Toledo.

Canteen Service Co. of Toledo was incorporated as an Ohio corporation on March 16, 1946, and was principally engaged in the operation of vending machines in Lucas, Fulton and Wood counties in Northwestern Ohio under a franchise granted by Automatic Canteen Company of America (hereinafter Automatic). Its sole shareholder was Ben T. Handwork. On May 10, 1946, Gladco entered into an agreement with Canteen Service whereby Gladco transferred to Canteen Service its vending machine business in exchange for payment of location commissions on all gross sales of candy, gum and nuts sold through vending machines previously operated by Gladco and at all locations where Gladco then operated food dispensing facilities. Gladco, pursuant to an option in the agreement, purchased seventy-five percent of Canteen Service's stock on or before October 31, 1946. Later, as a result of redemption of Handwork's remaining twenty-five percent

stock interest, Gladco became the sole owner of Canteen Service.

Southeastern Canteen Co. was incorporated as a Michigan corporation on January 19, 1956. Its business was the same as Canteen Service's—the sale of food and beverages through vending machines under a franchise granted by Automatic—but the territory of the business was Lenawee and Monroe counties in southeastern Michigan. Southeastern issued twenty shares of stock—fifteen to Virgil Gladieux and five to Ben Handwork. In 1959, Southeastern redeemed Handwork's stock, with Gladieux thereby becoming sole stockholder.

Thus, by 1960 Canteen Service Co., an Ohio corporation, was wholly owned by the Gladieux Corporation (Gladco) and the corporate shares of Gladco and Southeastern, the Michigan corporation, were wholly owned by Virgil T. Gladieux. Virgil and his wife, Beatrice G. Gladieux, were also the sole shareholders in twelve other corporations engaged in the merchandising and vending of food, beverages and gum in various areas of the United States. On June 30, 1960, Virgil and his wife agreed to transfer all fifteen corporations to ABC Vending Corporation, a large publicly owned Delaware corporation, in exchange for 80,000 shares of its stock, an option to purchase 5,000 additional shares, and an executive position with ABC at an annual salary of $62,500.[1] The franchise agreements which Canteen Service and Southeastern had with Automatic, however, gave Automatic a right to withhold consent to a transfer of Canteen Service or Southeastern.[2] Automatic exercised this right and refused to permit the transfer of either company to ABC. Virgil

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[1] ABC, at the time, had 8,522 shareholders owning 1,228,328 shares of common stock included 48,960 treasury shares.

[2] Article V, Section 25 of Franchise Agreement.

Gladieux's arrangement to circumvent this refusal brought about most of the litigation before us.

Prevented from total performance of the June 30, 1960 agreement, Virgil, on January 26, 1961, by "Supplemental Agreement" transferred to ABC his other thirteen corporations, including Gladco, in exchange for 68,500 shares of stock, the stock option, and the executive position with ABC.[3] There were also negotiated, as of January 31, 1961, agreements between Gladco (then owned by ABC) and Canteen Service (controlled by Virgil Gladieux), and between Gladco and Southeastern (still controlled by Virgil). The terms of these latter agreements were substantially as follows: Canteen Service and Southeastern (petitioners) would transfer to Gladco their tangible physical assets at a price determined by their net book value as of October 1, 1960. Gladco would then lease back to petitioners all such assets for a term of twenty years, beginning October 1, 1960, and would lease to petitioners "all additional equipment necessary for the operation of the vending machine business." Petitioners would pay to Gladco for such leased assets a "rental" equal to ten percent of their gross sales attributable to the vending machine business during the term of the lease, provided such "rental" did not create a deficit in the net income of either petitioner. Petitioners would pay increased "fixed location commissions" to Gladco with respect to all sales at vending machine locations derived through Gladco, Virgil or any affiliated corporations. In consideration for the transfer of their physical assets, Gladco paid to Canteen Service and Southeastern

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[3] The six-month delay in negotiations was caused by the fact that Automatic's refusal to consent was submitted to arbitration, and the arbitrator's decision (in Automatic's favor) was not rendered until December 27, 1960.

$184,659.85 and $5,109.43, respectively. All of this money was used along with $201,827.30 and $52,863.64, respectively, out of their other funds, to purchase 11,500 shares of ABC stock in the spring of 1961. By this purchase, Virgil then held, directly or indirectly, the 80,000 shares of stock he would have acquired had the original agreement not been blocked by Automatic.

The Commissioner made the following deficiency assessments: against Canteen Service Co. of Toledo and Southeastern, together, $58,863.71 for the tax year ending September 30, 1961;[4] against Southeastern Canteen Co. (the Michigan Corporation), $4,936.82, $5,458.89 and $6,194.61 for the tax years ending October 3, 1959, October 1, 1960, and September 30, 1961, respectively.[5]

We consider then, 1) disallowance of rental payments made by petitioners to Gladco, 2) disallowance of location commissions paid by petitioners to Gladco, and 3) disallowance of surtax exemption claimed by Southeastern.

1) Purported Rental Payments.

For their fiscal year ending September 30, 1961, petitioners Canteen Service and Southeastern claimed deductions of $121,172.15 and $12,211.30, respectively, for amounts paid as rent to Gladco pursuant to the sale-leaseback agreement of January 31, 1961. These deductions were claimed under Section 162(a)(3) of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a)(3), which reads in pertinent part as follows:

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[4] This amount represents the disallowance of a portion of the rental and location commission deductions taken by Canteen Service and Southeastern.

[5] These were the consequence of disallowing Southeastern's surtax exemption for the mentioned years.

"(a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The Commissioner, however, disallowed petitioners' claimed deductions to the extent that they exceeded $53,592.79 and $1,906.59, respectively. He based his determination on the conclusions that the sale-leaseback agreement was not negotiated at arm's length between adverse parties and that the claimed rentals did not represent the fair rental value of the assets leased. The fact that the parties designated, and one party became obligated to pay to the other, a specified amount as rent does not bind the government to treat that amount as rent. *Catherine G. Armston,* 12 T.C. 539, 548 (1949), *aff'd sub nom. W. H. Armston Co., Inc. v. Comm'r,* 188 F(2) 531, 533 (5th Cir. 1951). Where there is an absence of arm's length dealing, the Commissioner may inquire into what constitutes reasonable rental to determine whether the amount paid exceeds what would have been paid had the parties dealt at arm's length. *Roland P. Place,* 17 T.C. 199, 203 (1951), *affirmed,* 199 F(2) 373 (6th Cir. 1952), *cert. denied,* 344 U.S. 927 (1953). See also, *J. J. Kirk, Inc.,* 34 T.C. 130 (1960), *affirmed* 289 F(2) 935 (6th Cir. 1961).[6]

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[6] This power given the Commissioner is but a corollary to the broader proposition that the substance of a transaction rather than the form is controlling. *Gregory v. Helvering,* 293 U.S. 465, 79 L.Ed. 596 (1935); *Smith v. Comm'r,* 370 F(2) 178 (6th Cir. 1966).

The issue is whether the involved parties negotiated the sale-leaseback agreement at arm's length. This is an issue of fact, and the Tax Court's findings can be reversed only if found to be clearly erroneous. *Comm'r v. Duberstein*, 363 U.S. 278, 291 (1960). We consider that the Court's findings are not clearly erroneous, and agree with the following from the Tax Court's decision:

> "The dominant motives of both Virgil and ABC throughout the negotiations which culminated in the sale-leaseback agreements are crystal clear. Virgil sought to obtain ABC stock and an executive position with the company and ABC sought to acquire Virgil's 15 food service companies. In light of these facts, we think it abundantly clear that the sale-leaseback agreements were designed solely to fulfill the personal objectives of Virgil. There was no legitimate business purpose for petitioners to undertake the sale and subsequent leaseback of their tangible assets other than to satisfy Virgil's purpose of shifting income from petitioners to Gladco in order to induce ABC to go through with the deal. Thus, this is not a case where a corporation entered a sale-leaseback arrangement in order to generate needed cash for business expansion. To the contrary, all the money received by petitioners upon the sale of their tangible assets, together with substantial additional amounts, was used to purchase ABC stock, thus serving no meaningful business purpose to petitioners.
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> "Petitioners' position is further weakened by the fact that during the entire negotiations leading up to the execution of the sale-leaseback agreements, the owner of both the lessor (Gladco) and the lessees (petitioners) was the same person, Virgil Gladieux. Petitioners' attempt to transform such an identity of interest into a relationship which petitioners characterize as adverse, transgresses reasonable imagination. All the more so since the facts show that

> the sale-leaseback agreements were not intended to be ends in themselves but merely steps in an integrated plan to secure to Virgil and ABC advantages which could not benefit petitioners in any meaningful way. From a review of all the facts bearing on this issue, which have been set out at length in our findings, we are convinced that the sale-leaseback agreements in question were not the result of arm's length negotiation between adverse parties and, therefore, we must determine whether the purported rentals were 'in excess of what the lessee[s] would have been required to pay had * * * [they] dealt at arm's length with a stranger.' *Roland P. Place, supra.*"

An important consideration is that Virgil Gladieux was, on the one hand, sole stockholder of the petitioners and, on the other, a stockholder and executive of ABC. It was not essential to him that he profit in his capacity *as owner of the petitioners*, but only that he profit in the sale-leaseback transaction *as a whole.*

Petitioners do not squarely raise the contention that, whether or not the involved negotiations and dealings were at arm's length, the rental payments were reasonable. We are not compelled to reach this question but the following, brought to our attention by the government's brief, persuades us that the Tax Court's determination of deficiency was not clearly erroneous:

> "Taxpayers argue that the rentals paid were reasonable in light of the fact that the lessor (Gladco) furnished them with additional equipment for their use. However, even taking this fact into consideration, the record shows that the glaring disparity is still present. For the period October 1, 1960, through October 3, 1964, taxpayer, Southeastern, paid the lessor (Gladco) total rentals of $62,487.98, receiving on the other hand for the period October 1, 1960, through December 27, 1964, additional equipment

costing Gladco $12,097.91. For the same periods Canteen Service paid Gladco total rentals of $432,835.18, receiving from Gladco additional equipment costing the latter $595,591.12. Thus, Southeastern paid Gladco $62,487.98 to lease equipment valued by the parties at $17,207.34 ($5,109.43 sales price plus $12,097.91) and Canteen Service paid Gladco $432,835.18 to lease equipment valued by the parties at $780,250.97 ($184,659.85 sales price plus $595,591.12). Moreover, an even greater disparity existed for the period October 1, 1960, through December, 1962 with respect to assets costing Gladco a total of $251,197.03 which were rented to Canteen Service for $208,176.58 as of September 29, 1962."

2) Location Commissions.

In 1946, subsequent to Canteen Service's incorporation, it entered into an agreement with Gladco (then named Buddies Lunch System, Inc) whereby Gladco transferred to Canteen Service its vending machine business in exchange for payment of location commissions on sales of candy, gum and nuts sold through vending machines previously operated by Gladco or at locations where Gladco then operated food dispensing facilities. At the time, Canteen Service was wholly-owned by Ben Handwork, and Gladco by Virgil and Nelson Gladieux. This 1946 agreement was continued and substantially modified and extended by the January 31, 1961 agreement between Canteen Service (then controlled by Virgil) and Gladco (then owned by ABC). An agreement of the same date between Southeastern and Gladco established location commissions payable from Southeastern to Gladco, although there is no evidence of a previous agreement between these parties.

In their fiscal year 1961, Canteen Service and Southeastern paid or accrued to Gladco location commissions

of $134,920.68 and $9,174.57, respectively. In their corporate income tax returns for that year, they deducted those amounts as "ordinary and necessary expenses paid or incurred * * * in carrying on any trade or business," under Section 162(a) of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a).

Of these amounts, the Commissioner disallowed $74,088.26 and $1,593.84, respectively. $69,429.16 of Canteen Service's disallowance was attributable to the entire location commissions at two large corporations, LOF Glass (Libbey-Owens-Ford) and Toledo Scale. The remaining amount disallowed to Canteen—$4,659.10—and the full amount disallowed to Southeastern constituted excess location commissions computed under the higher rates determined in the January 31, 1961 agreement but applicable retroactively, beginning October 1, 1960, at a time when the 1946 agreement was still in effect.

The Commissioner found, and the Tax Court affirmed, that the disallowed portions of the location commissions were not "ordinary and necessary" business expenses, nor were they "appropriate and helpful" to petitioners' business. See *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966). With regard to the location commissions at LOF Glass and Toledo Scale, the Tax Court stated:

> "[P]rior to the 1961 agreement, imposing increased location commissions on petitioners retroactively to October 1, 1960, Gladco had waived all commission payments due from Canteen Service on the LOF Glass and Toledo Scale business. The waivers as to those commission payments occurred at the time Canteen Service began making location commission payments directly to the industrial clients, LOF Glass and Toledo Scale. Thus, for several years prior to the 1961 agreement, Canteen Service was not required to make any location commission payments to Gladco

on its LOF Glass and Toledo Scale business. However, in order for Virgil's deal with ABC to be consummated, it became necessary to shift all income of petitioners to Gladco. To accomplish this objective Canteen Service was required to reinstitute location commission payments to Gladco on its LOF Glass and Toledo Scale business, which was, of course, in addition to the amounts Canteen Service was required to pay Gladco as purported rental payments. We can find no reasonable explanation for reinstituting such location commissions except as a further device to accomplish the shifting of all petitioners' income to Gladco. The record specifically shows that at the time Virgil was negotiating with representatives of ABC, he felt ABC was intending to acquire, by the various agreements, all the operating income of petitioners.

"Even more objectionable to allowing Canteen Service's location commissions in question is the fact that not only prior to, but for the year in question, Canteen Service paid location commissions directly to LOF Glass and Toledo Scale for the right to operate vending machines on the premises of those industrial customers. In 1961, Canteen Service paid to those customers the combined amount of $12,401.70 in location commissions. In spite of this, petitioners contend that they are entitled to deduct the further amount of $69,429.16 paid to Gladco as location commissions for vending machine sales on the premises of the same two customers. The record fails to reflect any business or economic need for Canteen Service to make the location commission payments in question, and in light of the fact that Canteen Service was already making payments directly to LOF Glass and Toledo Scale, we know of none. Lacking in any meaningful business purpose we fail to see how the payment of such obviously unnecessary amounts could be 'appropriate and helpful' for the development of Canteen Service's business."

With regard to the additional, retroactive commissions, the Court found that the Commissioner had disallowed only that amount which,

> "exceeded the commissions computed pursuant to the rates in effect under the agreement between Canteen Service and Gladco, dated May 16, 1946. Thus, for the period October 1, 1960, through February 20, 1961, respondent disallowed only $4,659.10 out of $25,999.22 claimed by Canteen Service and disallowed $1,593.84 out of $3,558.36 claimed by Southeastern. Since respondent has allowed petitioners' claimed location commissions, although at the lower rates in effect prior to the 1961 agreements, the only question presented is whether respondent correctly disallowed the retroactive increases required by the 1961 agreements.
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> "Petitioners contend that the location commissions were made retroactive to October 1, 1960, because that was the date, originally contemplated by ABC and Virgil in their agreement of June 30, 1960, when the exchange of Virgil's 15 companies was to be made in return for ABC stock. This fact is apparently relied upon by petitioners to justify making the commission payments retroactive to October 1, 1960. Even conceding that the October 1 date was set for that purpose, which the record does not necessarily support, we think petitioners' position is irrelevant with regard to the payment of location commissions by Canteen Service and Southeastern inasmuch as the limited question for our determination is whether the retroactive payments constituted ordinary and necessary business expenses to petitioners. Thus, while the October 1 date may have been required in order for Virgil to consummate his deal with ABC, we find no valid business reason in the record for petitioners to retroactively pay increased location commissions for more than 4 months. The record is devoid of any meaningful economic benefit flowing to petitioners for such

payments, and consistent with our prior determination, *supra*, we think the retroactively increased rates imposed upon petitioners under their 1961 agreements with Gladco merely constituted a necessary concession on Virgil's part, in order to consummate his personal deal with ABC, irrespective of whether such a result proved 'appropriate and helpful' for the development of petitioners' business."

The question of whether these claimed deductions come within Section 162(a) is a factual determination. *Comm'r v. Heininger*, 320 U.S. 467, 475, 88 L.Ed. 171, 177 (1943). It is thus reversible only if clearly erroneous. *Comm'r v. Duberstein, supra*. We are of the opinion that the Tax Court's findings and conclusions in this regard are not clearly erroneous.

Petitioners' principal argument is that the location commissions were adopted by the 1946 agreement negotiated at arm's length between Canteen Service and Gladco which were, at that time, owned by separate, unrelated parties. The 1946 agreement covered only commissions on candy, gum and nuts. The 1961 agreements encompassed commissions on seven additional items: coffee, pastry, milk, ice cream, sandwiches, hot foods, and cigarettes. The 1946 agreement was not merely "supplemented" by the 1961 agreement, as petitioners argue, but was broadened and extended manyfold. It cannot be considered an erroneous finding that the disallowed location commissions were derived from the 1961 agreements, and failed to serve an excludable business purpose.

3) Denial of Surtax Exemption.

In 1956 Southeastern Canteen Co. was organized as a Michigan corporation by Virgil Gladieux and Ben T. Handwork, who then were the owners of Canteen Service Co. of

Toledo. Later Virgil Gladieux became its sole shareholder. Section 11 of the Internal Revenue Code of 1954, 26 U.S.C. § 11, imposes a tax on the taxable income of corporations consisting of a normal tax and a surtax. Under Section 11(d), the surtax is not imposed upon the first $25,000 of a corporation's taxable income. Both Canteen Service and Southeastern had claimed his $25,000 surtax exemption each year. The Commissioner, however, determined that Southeastern—which engaged in the same business as Canteen but in two Southeastern Michigan counties while Canteen operated in Northwest Ohio—was not entitled to the surtax exemption for its fiscal years ending October 3, 1959, October 1, 1960, and September 30, 1961, on the authority of Section 269(a) of the Code, 26 U.S.C. § 269 (a), which reads in pertinent part:

"In general—if—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation,

* * * * *

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2) control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation."

Specifically, the Commissioner found that Virgil Gladieux and Ben Handwork, sole stockholders in Canteen Service, in 1956 formed or "acquired" Southeastern, of which they

became sole stockholders, for the principal purpose of gaining a second $25,000 surtax exemption.

The Tax Court affirmed this determination, stating, "Upon a consideration of the entire record, we think the facts require us to hold that Southeastern was incorporated in 1956 for the principal purpose of avoiding Federal income taxes * * *."

The issue, then, is whether the "principal purpose" of Southeastern's acquisition was "avoidance of Federal income tax." "Principal purpose" is further defined by Treasury Regulations, Section 1.269-3(a), 26 C.F.R. § 1.269-3(a), as follows:

> "If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of Section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom."

This issue involves a factual determination which can be reversed only if found to be clearly erroneous. *Comm'r v. Duberstein*, 363 U.S. 278 (1960). The Commissioner's disallowance of the surtax exemption is presumptively correct, and the burden of disproving such determination by a preponderance of the evidence is on petitioners. 26 C.F.R. § 1.269-5; *Welch v. Helvering*, 290 U.S. 111, 115, 78 L.Ed. 212, 215 (1933); *Helvering v. Taylor*, 293 U.S. 507, 515, 79 L.Ed. 623, 629 (1935).

We believe, however, that petitioners met their burden of proving by a preponderance of the evidence that the

principal purpose of forming Southeastern was not tax avoidance. At trial before the Tax Court, the sole witness to testify on this issue was Virgil Gladieux, controlling stockholder of both Canteen Service and Southeastern at the time in question. Gladieux testified that no consideration to Federal income tax law was given at the time of Southeastern's incorporation,[7] and that the reason for a separate corporation was that "we needed identity, local identity, and we needed a Michigan image." Respondent urges that neither this Court nor the Tax Court is bound to accept the testimony of Gladieux, an interested party, even though not contradicted, citing *Quock Ting v. United States*, 140 U.S. 417 (1891). But this is not to say that clear, convincing and uncontradicted testimony can be ignored just because of the interest of the witness. The correct rule is recited in *Quock Ting*:

> "Undoubtedly, as a general rule, positive testimony as to a particular fact, uncontradicted by any one, should control the decision of the court; but that rule admits of many exceptions. There may be such an inherent improbability in the statements of a witness as to induce the court or jury to disregard his evidence, even in the absence of any direct conflicting testimony." 140 U.S. at 420.

Gladieux's testimony went unchallenged by the government. This Court has held that "where unimpeached, competent, and relevant testimony on behalf of a taxpayer is uncontradicted, it may not be arbitrarily discredited and disregarded, and the Tax Court cannot reject or ignore this evidence * * *." *Loesch & Green Const. Co. v. Comm'r*, 211 F(2) 210, 212 (6th Cir. 1954). See also, *Tank v. Comm'r*, 270 F(2) 477, 487 (6th Cir. 1959). The

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[7] The attorney employed by Gladieux in incorporating Southeastern, a Mr. Smith, was deceased at the time of hearing.

Treasury Regulations indicate that "a scrutiny of the entire circumstances" surrounding the acquisition must be made. 26 C.F.R. § 1.269-3(a). Obeying such Regulations, we are persuaded that a review of the "entire circumstances" substantiates Gladieux's testimony. Southeastern was given a separate "Michigan image" by Gladieux. Books and records of Canteen Service and Southeastern were kept separate and distinct. There were separate warehouses and bank accounts in Michigan. None of Canteen's inventory was used in Southeastern's operations. Southeastern's two resident managers were based in Adrian and Monroe, Michigan—the county seats of the two Michigan counties Southeastern serviced—rather than in Toledo where Canteen's headquarters was located. Virgil Gladieux had established a tradition of incorporating a new company whenever he initiated a new, albeit related, enterprise. In 1961 he controlled a total of fifteen corporations, all engaged in the food distribution business. For example, *Ohio* corporations, controlled by Gladieux, operated in-plant feeding at corporations in *Ohio* whose vending machines were serviced by Canteen Service, but in-plant feeding at the Revco Corporation plant in Deerfield, *Michigan*—in the vending machine territory of Southeastern—was performed by Buddies Lunch System, a Gladieux-controlled *Michigan* corporation.

The Tax Court sought to tarnish Gladieux's "Michigan image" argument by noting that "the franchise agreement under which Southeastern obtained virtually all its vending machines, specifically prohibited Southeastern from using its name on the vending machines in a manner which would give the appearance that Southeastern was the *owner* of the machines." (Emphasis supplied.) The franchise agreement, however, permitted Southeastern to advertise on the machines that it was *servicing* them.

In this way, Southeastern was able to effectively present a "Michigan image" to the public.

A recent Court of Claims case parallels the instant case in some respects. In *Louisville Store of Liberty, Ky., Inc. v. United States*, 179 Ct. Cl. 847, 376 F (2) 314 (1967), a partnership consisting of five related partners owned thirteen clothing stores in nine Kentucky towns. In 1959, the partners incorporated eleven of the stores in eleven separate corporations. The Commissioner, relying on Section 269, allowed but one surtax exemption to the entire group of corporations. The Court of Claims, adopting the opinion of Court Commissioner Day, determined that the purpose of incorporation of the companies was not principally to avoid tax within the meaning of Section 269, and held that each company was entitled to the benefit of the $25,000 surtax exemption. The Commissioner's opinion agreed with the United States Senate Finance Committee that, where *corporations controlled by the same persons engage in the same type business in different geographic locations*, there are legitimate business reasons for establishing separate corporations.

> "Congress, in considering the Revenue Act of 1964, reviewed the application of the provisions of section 269, concluding that there were indeed legitimate business reasons in the use of multiple corporations where corporations owned or controlled by the same interests, as here, conduct the same type of business in different geographical locales, as here. The Senate Finance Committee made the following comment in this connection:
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> * * * * *
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> " 'While the House and your committee recognize the advantages of use of multiple corporations, it is believed, as it has been in the past, that, where corporations owned and controlled by the same interests

engage in different businesses in the same area or conduct the same type business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, the House and your committee do not intend to encourage the formation of these multiple corporations and therefore propose to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes.'

* * * * *

"Sen. Rep. 830, 88th Cong. 2d Sess., pp. 149-150, Cum. Bull. 1964-1 (Part 2) pp. 653-654.

"The House Ways and Means Committee adopted similar language in its report on the same subject. See H.R. Rep. No. 749, 88th Cong. 1st Sess. Cum. Bull. 1964-1 (Part 2) p. 242." 376 F(2) at 319.

Such, in substance, were the holdings in *Bush Hog Mfg. Co.*, 42 T.C. 713, 726-729 (1964), and *V. H. Monette & Co.*, 45 T.C. 15, 33-35 (1965), *aff'd on other grounds*, 374 F(2) 116 (4th Cir. 1967).

We hold that, under the circumstances where the controlling stockholder of both the parent and acquired corporation testified that the reason for creating a separate corporation to engage in the same business in a different geographic location was to present a local image and was not tax avoidance, where the testimony was uncontroverted and unimpeached, and where there was substantial evidence to corroborate his testimony regarding the presentation of the local image, it was improper for the Commissioner to deny the acquired corporation its

$25,000 surtax exemption. To the extent that this holding may be factually inconsistent with the Tax Court's findings of fact, we hold, obedient to *Comm'r v. Duberstein, supra,* that its findings are clearly erroneous.

The judgment of the Tax Court sustained the Commissioner's disallowance of rental and location commission payments is affirmed; the judgment of the Tax Court sustaining the Commissioner's disallowance of the surtax exemption as to Southeastern Canteen Co. is reversed and vacated. Each party shall pay its own costs.

APPENDIX B.

MEMORANDUM FINDINGS OF FACT AND OPINION OF THE UNITED STATES TAX COURT.

(Filed September 19, 1967.)

WITHEY, *Judge*: Respondent determined deficiencies in petitioners' income tax for the years and in the amounts as follows:

Petitioner	Docket No.	Taxable year ended	Deficiency
Southeastern Canteen Co.	4301-64	Oct. 3, 1959	$ 4,936.32
		Oct. 1, 1960	5,458.89
Canteen Service Co. of Toledo	4302-64	Sept. 30, 1961	6,194.61
		Sept. 30, 1961	58,863.73

The cases have been consolidated and will be decided together.

The issues for decision are:

(1) Whether the purported rentals paid or accrued in favor of the Gladieux Corporation by petitioners for their fiscal year ended September 30, 1961, constitute allowable deductions from their respective gross incomes in that year, pursuant to section 162(a)(3) of the Internal Revenue Code of 1954.[1]

(2) Whether the location commissions paid or accrued in favor of the Gladieux Corporation by petitioners for their fiscal year ended September 30, 1961, constitute allowable deductions from their respective gross incomes in that year, pursuant to section 162(a) of the Code.

(3) Whether respondent properly disallowed Southeastern Canteen Co. a statutory surtax exemption for its fiscal years ended October 3, 1959, October 1, 1960, and September 30, 1961, pursuant to section 269 or 1551 of the Code.

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[1] All statutory references hereinafter are to the Internal Revenue Code of 1954.

FINDINGS OF FACT.

Some of the facts have been stipulated and are found accordingly.

Petitioner Canteen Service Co. of Toledo (hereinafter called Canteen Service) is, and at at all times pertinent hereto was, a corporation incorporated March 16, 1946, under the laws of the State of Ohio with its principal office in Toledo, Ohio. For the tax year ended September 30, 1961, Canteen Service filed its corporate income tax return with the district director at Cleveland, Ohio, listing its corporate address as 3156 Bellevue Road, Toledo 6, Ohio.

Petitioner Southeastern Canteen Co. (hereinafter Southeastern) is, and at all times pertinent hereto was, a corporation incorporated under the laws of the State of Michigan on January 19, 1956. Its registered office was in Detroit, Michigan, and its corporate officers were housed in Toledo, Ohio. For the tax years ended October 3, 1959, October 1, 1960, and September 30, 1961, Southeastern filed its corporate income tax returns with the district director at Cleveland, Ohio, listing its corporate address as 3156 Bellevue Road, Toledo 6, Ohio.

At the time Canteen Service was incorporated, its entire capital common stock was issued to Ben T. Handwork (hereinafter Handwork) in exchange, among other things, for the use by Canteen Service of a franchise previously granted to Handwork by Automatic Canteen Company of America (hereinafter sometimes Automatic) for the sale of candy, gum, nuts, and related items through vending machines. In early 1953, Canteen Service, with the oral permission of Automatic, began operating eight canteen locations at the Revco Manufacturing Co. in Deerfield, Lenawee County, Michigan. On May 15, 1956, Canteen Service filed a notice of withdrawal with

the Michigan Corporation and Securities Commisssion and, subsequent to that date, no longer conducted business in Michigan.

During the tax year involving Canteen Service, 1961, its books and records were maintained under the accrual system of accounting and the 13-period system of tabulating its income and expenses was employed, each such period consisting of 4 weeks. During that year, Canteen Service sold food and beverages through vending machines in certain territories in western Ohio, such territories being among those originally designated in a franchise and distributor's lease agreement entered into between Automatic and Handwork on July 6, 1947, and assigned to Canteen Service on that day by Handwork with the consent of Automatic. Under this franchise and lease agreement, Canteen Service leased canteens[2] from Automatic in its fiscal year 1961, in numbers varying from 1,627 to 1,676, and reported to Automatic gross sales from those canteens of $1,318,901. Canteen Service reported on its tax return for fiscal 1961, gross sales of $1,651,490.29.[3]

Upon the incorporation of Southeastern in 1956, its authorized capital stock consisted of 1,000 common shares of the par value of $50. Of that amount, Virgil Gladieux (hereinafter sometimes referred to as Virgil) and Handwork subscribed for 15 shares and 5 shares, respectively. On July 21, 1959, Southeastern redeemed the 5 shares owned by Handwork which redemption resulted in Virgil's becoming the owner of Southeastern's entire outstanding common stock.

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[2] Under the franchise and lease agreement, a "Canteen" was defined as a candy, gum, nut, or other vending machine, although that word will sometimes be used hereinafter to designate more than one such machine at a given location.

[3] The additional revenue reported on its tax return was attributable to vending machines owned outright by Canteen Service.

During the tax years involving Southeastern, its books were maintained under the accrual system of accounting and the 13-period system of tabulating its income and expenses was employed, each such period consisting of 4 weeks. During those years, Southeastern had the exclusive rights to the sale of food and beverages through vending machines in Lenawee and Monroe Counties in southeastern Michigan, such counties being among those originally designated in a franchise and distributor's lease agreement entered into between Automatic and Handwork on January 20, 1956, and assigned to Southeastern on that day by Handwork with the consent of Automatic. Under this franchise and lease agreement, Southeastern leased canteens from Automatic in its fiscal year 1961, in numbers varying from 252 to 273, and reported to Automatic gross sales from these canteens of $185,469.

Southeastern's franchise from Automatic provided not only for exclusive territory but also for the leasing of canteens from Automatic to Southeastern for rent. It also provided that Southeastern was to periodically deliver to Automatic a report of the canteen sales, from which such rentals were determined. It provided further that title to the rented canteens was to remain in Automatic, that Southeastern was prohibited from attaching its name to the canteens except to show that it was servicing such equipment, that the franchise could be canceled under certain circumstances, and that a sum of $50 would be payable by Southeastern to Automatic, as liquidated damages, for each canteen if either the franchise was canceled or if there was any interference by Southeastern with the continued ownership and use of such canteen location by Automatic. The franchise further provided that if Handwork disposed of, or attempted to dispose of the franchise by sale, assignment, transfer, rent, or sub-

lease, without the prior consent of Automatic, the franchise agreement was to be null and void.

Southeastern commenced business on January 21, 1956, starting its route operations with vending machines, inventory, and trucks. As of that date, Southeastern's capital was $1,000. On January 23, 1956, Southeastern's directors, at their first board meeting, adopted resolutions, among other things, to purchase vending machines from Automatic and to open an account at a bank in Monroe, Michigan. Southeastern employed a resident of each of those counties to supervise the company's operations. Thus, at its inception, Southeastern's operations were conducted from the Michigan residences of those two employees. Later, Southeastern established warehouse and refrigeration facilities in Monroe County, Michigan. Although Southeastern acquired certain operating assets and leased vending machines from Automatic, as provided in its franchise agreement, Automatic had no stock interest in Southeastern.

Prior to May 10, 1946, the Gladieux Corporation (hereinafter Gladco)[4] was principally engaged in the business of operating cafeterias and lunch counters, and dispensing food in several manufacturing plants in the city of Toledo and vicinity. It also sold candy, gum, and nuts both over its counters and through vending machines at such food locations, at gas stations, and other locations. Gladco's books and records were maintained on the accrual system of accounting and on a calendar year basis.

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[4] Gladieux Corporation's predecessor business was incorporated in 1931 under the name of Buddies Box Lunch, Inc. It was only after three corporate name changes that the name of the business became Gladieux Corporation on November 2, 1960. To avoid confusion, use of the name Gladco will be used to refer to the same business, both before and after its name became Gladieux Corporation.

As of May 10, 1946, Gladco's outstanding capital stock was owned equally by Virgil Gladieux and his brother Nelson. On May 25, 1955, Virgil became the sole stockholder of Gladco.

On May 10, 1946, an agreement was entered into between Gladco and the Gladieux brothers, on the one hand, and Canteen Service and Handwork, on the other. Pursuant to the agreement, Gladco transferred its vending machine business in Lucas, Fulton, and Wood Counties, Ohio, to Canteen Service. The agreement provided, in part, that Canteen Service would pay Gladco a 12 percent commission on all gross sales of candy, gum, and nuts sold by Canteen Service through vending machines at all locations within Lucas, Fulton, and Wood Counties, Ohio, where Gladco "now or hereafter operate[s] cafeterias, lunch counters or other food dispensing facilities." Pursuant to that provision and prior to 1958, Canteen Service paid a 12 percent location commission to Gladco on sales made by Canteen Service through vending machines located at the facilities of Libbey-Owens-Ford Glass Company (hereinafter LOF Glass). The 1946 agreement further provided that Canteen Service would assume Gladco's obligation to pay to the owners of the locations where Gladco vending machines were operated, but where no counter food was sold, an 8 percent commission on the gross sales of candy, gum, and nuts sold through vending machines. It was provided, however, that Canteen Service would not be required to pay Gladco any commission on sales made through vending machines at such locations.[5]

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[5] While Southeastern never entered into any written agreement respecting payment of location commissions to Gladco, it followed the same pattern of paying such commissions on vending business generated by Gladco's in-plant feeding business as did Canteen Service.

Prior to 1958, Canteen Service had paid location commissions to Virgil on the LOF Glass business. In 1958, LOF Glass negotiated for location commissions to be paid directly to it by Canteen Service. Subsequently, Canteen Service, as the result of a waiver by Virgil and the Gladieux interests, neither paid nor accrued any further location commissions to Virgil or Gladco on the LOF Glass business until October 1, 1960, when such payments were again required pursuant to the sale-leaseback agreement between Canteen Service and Gladco, dated January 1, 1961.

Beginning in 1953, Canteen Service paid location commissions to Toledo Scale. Although Canteen Service did not pay Virgil or Gladco additional location commissions, as a result of negotiations between Virgil and Toledo Scale in 1955 or 1956, Toledo Scale thereafter remitted to Gladco approximately 85 percent of the commissions received by Toledo Scale from Canteen Service. Canteen Service, however, never paid or accrued location commissions directly to Gladco for vending machine sales at Toledo Scale until October 1, 1960, pursuant to the sale-leaseback agreement between Canteen Service and Gladco, dated January 31, 1961.

The transfer of Gladco's vending operations to Canteen Service, pursuant to the agreement of May 10, 1946, appealed strongly to Virgil for financial reasons since, pursuant to Automatic's franchise arrangement under which Canteen Service was then operating, Canteen Service could lease its vending equipment from Automatic whereas up to that time Gladco was compelled to purchase such equipment thereby limiting its financial resources for expansion. The agreement also appealed to Gladco inasmuch as it provided an option pursuant to which Gladco could purchase up to 75 percent of the stock in

Canteen Service on or before October 31, 1946. In the event such option was exercised and in the further event Handwork or Gladco later wished to sell their respective stockholdings, they were required to offer them to each other under a reciprocal right of first refusal. Gladco later exercised its right of purchase, and as a result of Canteen Service's subsequent redemption of Handwork's 25 percent stock interest in Canteen Service, Gladco became the sole owner of Canteen Service.

After May 10, 1946, as vending machines were adapted to handle food products other than candy, gum, and nuts, such as milk, coffee, and ice cream, Virgil and Gladco exacted varying rates of location commissions from Canteen Service depending upon the relative profit margins of the foods being vended as well as the amount of location commissions Gladco was required to pay to its industrial clients. Thus in time there arose an inconsistent pattern of location commissions payable to Gladco by Canteen Service.

On or about December 4, 1953, Gladco began operating a restaurant and cafeteria at the plant and facilities of Toledo Scale Co. of Toledo, Ohio (hereinafter Toledo Scale), and continued such operations throughout Canteen Service's taxable year in question. Also, about December 4, 1953, Canteen Service was permitted to install canteens at nine different plant locations of Toledo Scale.

For a period occurring between 1953 and 1960, Gladco waived the location commissions payable to it by Canteen Service on the Toledo Scale business and did not again require commission payments to be made to it on that business until the sale-leaseback agreement entered into between it and Canteen Service on January 31, 1961, which agreement increased such commission payments retroactively to October 1, 1960.

Gladco, during the years in question, operated various food systems, such as in-plant employees feeding concerns, cafeterias, snack bars, and dining rooms. During those years and until February 2, 1961, of the outstanding capital stock of Gladco, consisting of 500 no par common shares, 499 shares were owned by Virgil and the remaining share by his wife.

On June 30, 1960, Virgil and his wife owned the entire outstanding capital stock of 15 corporations engaged in the merchandising and vending of food, beverages, cigarettes, and gum. Included among those 15 corporations were Canteen Service, Southeastern, and Gladco.

Immediately prior to June 30, 1960, ABC Vending Corporation (whose name has since been changed to ABC Consolidated Corporation and hereinafter will be referred to as ABC) was primarily engaged in the food and beverage merchandising and vending business with book net worth in excess of $16 million and with annual sales from its vending business exceeding $60 million. At that time, ABC was a publicly owned corporation with stock listed on the New York Stock Exchange. In January of 1961, it had 8,522 shareholders who owned 1,228,328 shares of common stock. Additionally, it held 48,960 shares of treasury stock. Prior to February 2, 1961, neither Virgil nor his wife owned any capital stock of ABC.

On June 30, 1960, ABC and Virgil entered into an agreement whereby Virgil agreed, among other things, to transfer to ABC all of the outstanding capital stock of the 15 corporations owned by him and his wife, in exchange for 80,000 shares of the capital common stock of ABC. The agreement provided that Virgil was to be retained by ABC in a "major managerial capacity" at an annual salary of

$62,500 for 5 years, after which his salary would be increased to $67,500. The agreement further provided that ABC would deliver to Virgil a stock option certificate giving him the right to acquire 5,000 shares of ABC common stock at a price equal to 85 percent of the market value of the stock on the New York Stock Exchange on the date of settlement of the foregoing agreement.

Automatic, relying on the provisions of the franchise agreement which it had entered into with Canteen Service on July 1, 1947, refused to consent to Virgil's attempted transfer to ABC of the outstanding capital stock of Canteen Service and Southeastern.[6] Pursuant to a section of that agreement which defined the procedure for handling a dispute as to petitioners' right to transfer, Automatic's refusal to consent to the sale and transfer was submitted to arbitration. On December 27, 1960, the arbitration tribunal decided that the withholding of such consent by Automatic was not unreasonable, arbitrary, or capricious.

Subsequent to the arbitration decision, Virgil and ABC executed a "Supplemental Agreement" on January 26, 1961, amending their agreement of June 30, 1960, by eliminating from the 1960 agreement the requirement that Virgil transfer the outstanding stock of Canteen Service and Southeastern to ABC. The amendatory agreement also reduced the number of ABC shares to be delivered to Virgil from 80,000 to 68,500.

Also, on January 26, 1961, Virgil, ABC, Canteen Service, Southeastern, and Gladco executed an agreement which provided that since Virgil was no longer able to transfer petitioners' stock to ABC, Gladco and petitioners

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[6] The franchise agreement provided that petitioner could not, without the consent of Automatic, sell, assign, or transfer any interest in the agreement. It further provided that Automatic would not "unreasonably, arbitrarily or capriciously" withhold its consent to such a sale, assignment, or transfer.

would enter into an agreement which would provide, among other things, that: (1) petitioners would sell and transfer to Gladco their designated tangible physical assets in the following amounts: $184,659.85 as to Canteen Service and $5,109.43 as to Southeastern;[7] (2) Gladco would lease back to petitioners all such assets for a term of 20 years from October 1, 1960, with the further agreement that during that term Gladco would provide and lease to petitioners "all additional equipment necessary for the operation of the vending machine business" conducted by petitioners;[8] (3) petitioners would pay to Gladco for such leased assets a "rental" equal to 10 percent of the gross sales from the vending machine business "on and after October 1, 1960, and until the end of the term of the said lease and any extended term thereof";[9] (4) such "rentals" were not to be such in amount as would create a deficit in net income of either petitioner, net income being computed—

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[7] The amount Gladco agreed to pay petitioners for their tangible physical assets constituted their net book value, after accrued depreciation as shown on petitioners' books as of October 1, 1960. Included in such assets transferred were 299 vending machines owned by Canteen Service and 4 vending machines owned by Southeastern. Journal entries reflecting the sale were posted on the books of Gladco and each petitioner on February 18, 1961.

[8] For the period October 1, 1960, through December 27, 1964, Gladco purchased "additional equipment" for lease to petitioners in the following amounts: As to Canteen Service, $595,591.12, and as to Southeastern, $12,097.91. For the period October 1, 1960, through December 1962, "additional equipment" in the amount of $66,537.18 was purchased for Canteen Service.

[9] For the period October 1, 1960, through October 3, 1964, petitioners made "rental" payments to Gladco in the following amounts: Canteen Service, $432,835.18 and Southeastern, $62,487.98. For the period October 1, 1960, through September 1962, Canteen Service made "rental" payments to Gladco totaling $208,176.58.

> before Federal income taxes and before any salaries or expenses paid to or attributable to Virgil A. Gladieux or any member of his family, * * *

(5) any income, loss, or expense of petitioners "derived from or attributable to marketable securities or any other investment not germane to the operation of the vending machine business" was to be excluded from the determination of such net income; (6) petitioners were to pay increased fixed location commissions to Gladco as of October 1, 1960, with respect to all sales at all vending locations derived through Virgil, Gladco, or any affiliated corporations; and (7) Gladco could, at its option, extend the lease provisions for four consecutive periods of 20 years each. An agreement, dated January 31, 1961, containing the foregoing provisions, was executed by Gladco with each petitioner.[10] On February 2, 1961, pursuant to the terms of the "Supplemental Agreement" between Virgil and ABC, ABC delivered 68,500 shares of its capital common stock to Virgil and his wife in the respective amounts of 54,200 and 14,300 shares. On that same day, Virgil and his wife transferred to ABC the outstanding shares of stock in 13 corporations wholly owned by them, constituting all of the corporations referred to in the agreement dated June 30, 1960, with the exception of Canteen Service and Southeastern.

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[10] During the negotiations between ABC and Virgil in the latter part of 1960 and early part of 1961, which culminated in the January 1961 agreements, Virgil was of the view that the representatives of ABC contemplated that the sale-leaseback arrangements provided for in those agreements would take most of petitioners' profits. As anticipated, the leaseback arrangements absorbed all of the profits, with the exception of dividends from petitioners' ABC stock, of Canteen Service for its 1961 through 1963 fiscal years, and Southeastern for its 1961 through 1964 fiscal years.

The $184,659.85 received by Canteen Service under the January 31, 1961, agreement, together with an additional $201,827.30 of its other funds, was used by Canteen Service to purchase shares of ABC stock in the spring of 1961. Similarly, the $5,109.43 received by Southeastern under the January 31, 1961, agreement, together with an additional $52,863.64 of its other funds, was used by Southeastern to purchase ABC stock in the spring of 1961.[11] The total investment by petitioners of $444,460.22 in the spring of 1961, was used to purchase 11,500 shares of ABC stock.

During the negotiations between ABC and Virgil which were carried on both before and after the arbitration decision, Canteen Service was the owner of an 8½-acre parcel of vacant land, purchased by it in 1959, and located in Toledo, Ohio. Efforts were then being made by Canteen Service to sell the property and on April 27, 1961, the property was sold for $75,000 resulting in a net gain to Canteen Service, after expenses of sale, of $33,238.50. This property was not included in the assets of Canteen Service sold to Gladco under the agreement dated January 31, 1961, and Gladco at no time held title to this property.

For the fiscal year ended September 30, 1961, Canteen Service paid or accrued on its books as a liability in favor of Gladco, as purported rentals under the January 31, 1961, agreement, the sum of $121,172.15, including an amount of $28,897.95 with respect to the 8½-acre parcel

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[11] Although the January 31, 1961, agreement between Gladco and each petitioner provided that Gladco would deliver to each petitioner its promissory note in the amount of the respective purchase price, the journal entries on the books of Canteen Service and Southeastern, recording the sale of assets to Gladco, recited that Gladco "gave a note to ABC Vending Corporation for * * * [stated dollar amount] and we received check from ABC Vending Corporation."

sold by Canteen Service on April 27, 1961.[12] Canteen Service subsequently deducted the purported rentals from its gross income for its fiscal year 1961. During the calendar years 1960 and 1961, Gladco included as rental income, in its taxable income, the amount of $121,172.15 so paid to it or accrued as a liability in its favor by Canteen Service. Respondent allowed Canteen Service a rental deduction in the amount of $53,592.79 for the fiscal year ended September 30, 1961. The amount so allowed constituted the total depreciation, on a straight line method with various lives, charged off and deducted as an expense by Canteen Service for the fiscal year ended October 1, 1960, on the buildings, improvements, trucks, machinery, equipment, furniture, fixtures, and vending machines transferred by Canteen Service to Gladco pursuant to the agreement of January 31, 1961, thus disallowing as a deduction from the taxable income of Canteen Service $67,579.36 of such rentals so paid or accrued.

During the fiscal year ended September 30, 1961, Southeastern paid or accrued on its books as a liability in favor of Gladco, as purported rentals under the January 31, 1961, agreement, the sum of $12,211.30. Southeastern subsequently deducted the purported rentals from its gross income for its fiscal year 1961. During the calendar years 1960 and 1961, Gladco included as rental income in its taxable income the amount of such rentals so paid to it or accrued as a liability in its favor by Southeastern during the fiscal year ended September 30, 1961. Respondent allowed Southeastern a rental deduction in the amount of $1,906.59, for the fiscal year ended September 30, 1961.

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[12] During the negotiations between Virgil and representatives of ABC leading to the agreements of January 1961, it was agreed that the profit from the sale of this land would be included in the operating income of Canteen Service for the purpose of computing "rentals" under the contemplated contracts.

The amount so allowed constituted the total depreciation, on a straight line method with various lives, charged off and deducted as an expense by Southeastern for the fiscal year ended October 1, 1960, on the trucks, furniture, fixtures, and vending machines assigned by Southeastern to Gladco pursuant to the agreement of January 31, 1961, thus disallowing as a deduction from the taxable income of Southeastern $10,304.71 of such rentals so paid or accrued.

For the accounting periods ended October 29, 1960, November 26, 1960, December 24, 1960, January 22, 1961, and February 20, 1961, location commissions payable by Canteen Service to Gladco under their agreement of January 31, 1961, were retroactively increased and accrued, from and after October 1, 1960, by journal entries made to the books of Canteen Service on March 18, 1961. On April 15, 1961, Canteen Service paid these accruals to Gladco. The foregoing location commissions, as well as the location commissions paid or accrued for the accounting periods of Canteen Service commencing February 21, 1961, and ended September 30, 1961, together with the portions thereof which were allowed and disallowed by the Commissioner were as follows:[13]

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[13] In addition to locations commissions paid or accrued to Gladco by Canteen Service for its fiscal year 1961, Canteen Service also paid such commissions directly to LOF Glass in the amount of $8,656.76 and to Toledo Scale in the amount of $3,744.94.

Location Commissions Paid or Accrued by Canteen Service to Gladco

Origin of commissions	Accounting Periods Ended October 29, 1960 November 26, 1960 December 24, 1960		Ended January 22, 1961 February 20, 1961		February 21, 1961 to September 30, 1961		Total Fiscal year ended September 30, 1961	
	Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed
LOF Glass		$18,962.79		$10,107.40		$31,038.92		$60,109.11
Toledo Scale		2,280.44		1,451.31		5,588.30		9,320.05
All other business	$13,541.09[1]	3,043.45[2]	$7,799.03[1]	1,615.65[2]	$39,492.30[3]		$60,832.42	4,659.10
Total	13,541.09	24,286.68	7,799.03	13,174.36	39,492.30	36,627.22	60,832.42	74,088.26

[1] The location commissions allowed on "All other business" were determined under rates in effect prior to the January 31, 1961, agreement between Canteen Service and Gladco. The Commissioner further allowed as a deduction the amount of $28,547.88, which constituted all location commissions paid or accrued by Canteen Service during the fiscal year ended September 30,1961, with respect to all those locations which were not subject to the provisions of the agreement of January 31, 1961.

[2] The location commissions disallowed on "All other business" were the excess of the commissions, as computed under the rates set forth in Schedule II of the January 31, 1961, agreement between Canteen Service and Gladco, over the rates in effect prior to the agreement of January 31, 1961.

[3] These location commissions were determined under the increased rate structure established in Schedule II of the January 31, 1961, agreement between Canteen Service and Gladco.

Location commissions in the amount of $74,088.26 which were paid or accrued by Canteen Service for the fiscal year ended September 30, 1961, and which were disallowed by respondent as a deduction from the gross income of Canteen Service for Federal income tax purposes for said fiscal year, were included in the taxable income of the following corporations in the amounts and for the taxable years as follows:

Included by Gladco in its 1960 Federal income tax return	$24,286.68
Included by Gladco in its 1961 Federal income tax return	44,213.28
Included by Buddies of Lucas County, Inc. (one of the Gladco companies acquired by ABC) in its 1961 Federal income tax return	5,588.30
Total	74,088.26

For the accounting periods ended October 29, 1960, November 26, 1960, December 24, 1960, January 22, 1961, and February 20, 1961, location commissions payable by Southeastern to Gladco under their agreement of January 31, 1961, were retroactively increased and accrued, from and after October 1, 1960, by journal entries made to the books of Southeastern on March 18, 1961. The foregoing location commissions, as well as the location commissions paid or accrued for the accounting periods of Southeastern commencing February 21, 1961, and ended September 30, 1961, together with the portions thereof which were allowed and disallowed by the Commissioner, are as follows:

Location commissions in the amount of $1,593.84 which were paid or accrued by Southeastern for the fiscal year ended September 30, 1961, and which were disallowed by respondent as a deduction from the gross income of Southeastern for Federal income tax purposes for

Location Commissions Paid or Accrued by Southeastern to Gladco

Accounting Periods						Total	
Ended		Ended					
October 29, 1960 November 26, 1960 December 24, 1960		January 22, 1961 February 20, 1961		February 21, 1961 to September 30, 1961		Fiscal year ended September 30, 1961	
Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed
$1,138.63[1]	$995.63[2]	$825.89[1]	$598.21[2]	$5,616.21[3]	—	$7,580.73	$1,593.84

[1] The location commissions allowed were determined under rates in effect prior to the January 31, 1961, agreement between Southeastern and Gladco. The Commissioner further allowed as a deduction the amount of $2,046.81, which constituted all location commissions paid or accrued by Southeastern during the fiscal year ended September 30, 1961, with respect to all those locations which were not subject to the provisions of the agreement of January 31, 1961.

[2] The location commissions disallowed were the excess of the commissions, as computed under the rates set forth in Schedule II of the January 31, 1961, agreement between Southeastern and Gladco, over the rates in effect prior to the agreement of January 31, 1961.

[3] These location commissions were determined under the increased rate structure established by Schedule II of the January 31, 1961, agreement between Southeastern and Gladco.

said fiscal year, were included in the taxable income of Gladco in its Federal income tax returns as follows:

For the year 1960	$995.63
For the year 1961	598.21
Total	1,593.84

OPINION.

Issue 1. Purported Rental Payments.

For the fiscal year ended September 30, 1961, Canteen Service and Southeastern claimed as a deduction for purported rental payments, the respective amounts of $121,172.15 and $12,211.30, constituting the amounts they paid Gladco under certain sale-leaseback agreements dated January 31, 1961. Respondent has determined that the amounts so claimed are excessive to the extent that they exceed $53,592.79 as to Canteen Service and $1,906.59 as to Southeastern. Petitioners' principal contention appears to be that since the contracts imposing the questioned rentals were the result of arm's length negotiation between unrelated parties having adverse interests, the claimed rental deductions are not subject to attack by respondent as being unreasonable. Thus, it is argued that under the relevant statutory provision, section 162(a)(3) of the 1954 Code,[14] if the purported rentals were required to be paid pursuant to an arm's length agreement, the

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[14] Sec. 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

reasonableness of the rentals so paid cannot be judicially assailed. In considering a similar contention in *Roland P. Place,* 17 T. C. 199, 203 (1951), affd. 199 F.2d 373 (C.A. 6, 1952), certiorari denied 334 U.S. 927 (1953), this Court stated:

> The basic question is not whether these sums claimed as a rental deduction were reasonable in amount but rather whether they were in fact rent instead of something else paid under the guise of rent. The inquiry is whether the petitioner was in fact and at law "required" to pay these sums as rent. * * * When there is a close relationship between lessor and lessee and in addition there is no arm's length dealing between them, an inquiry into what constitutes reasonable rental is necessary to determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger. * * * [15]

Even though petitioners' contention might be correct if the purported rentals at issue were in fact arrived at as the result of arm's length negotiation between adverse parties, it is incumbent upon this Court to determine, in the first instance, whether such is in fact the case. In an attempt to support their position, that the sale-leaseback agreements were arrived at by arm's length negotiation between adverse parties, petitioners contend that those agreements arose out of negotiations between representatives of ABC, who, on the one hand, were representing Gladco, and Virgil, who, on the other hand, was representing petitioners. According to this theory, since ABC was to acquire Gladco from Virgil, ABC was interested in securing the best possible rental agreement for Gladco, whereas

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[15] To the same effect, see *J. J. Kirk, Inc.,* 34 T. C. 130 (1960), affd. per curiam 289 F. 2d 935 (C. A. 6, 1961); *Southern Ford Tractor Corporation,* 29 T. C. 833 (1958); and *E-Z Sew Enterprises, Inc. v. United States,* 260 F. Supp 100 (E. D. Mich. 1966).

Virgil, being the owner of Canteen Service and Southeastern, was striving to—

1. maintain the close relationship which had theretofore existed between Gladieux Corporation and Petitioners, since Gladieux Corporation had generated more than seventy-five per cent (75%) of the vending business enjoyed by Petitioners,

2. assure the Petitioners against any operating loss as the result of the rental arrangement, and

3. assure the Petitioners of the availability of funds for expansion, for acquisitions of other vending companies which he then had in mind and for the eventual purchase by Gladieux Corporation of the vending machines then being rented by the Petitioners from Automatic at no additional cost to Petitioners.

While the foregoing objectives may have existed in Virgil's mind prior to the execution of the sale-leaseback agreements, we are convinced, from a thorough consideration of the entire record, that such objectives were subservient to Virgil's principal objective of consummating a business deal with ABC along the lines established by their agreement of June 30, 1960.

Thus, the true motivating force for the sale-leaseback agreements was a desire on the part of Virgil to transfer his interest in his food service companies in exchange for an executive position with ABC at a starting salary of $62,500, acquisition of 80,000 shares of ABC stock, and a stock option for an additional 5,000 shares of ABC stock at 85 percent of market value. However, when Automatic, who was petitioners' franchisor as well as a competitor of ABC, objected to the transfer of petitioners' stock to ABC, and that objection was upheld by an arbitration award, it became necessary for Virgil to devise an alternative plan for accomplishing the same results without transferring

petitioners' stock to ABC. As shown by the record, Virgil and ABC agreed to a plan whereby Virgil would transfer ownership in 13 of his 15 companies to ABC, and funnel the profits of the remaining 2 companies, Canteen Service and Southeastern, into Gladco by way of the sale-leaseback agreements. While that plan did not secure to ABC the ownership of all 15 of Virgil's food service companies as ABC originally desired, the effect of the several agreements between the parties accomplished much the same thing inasmuch as ABC acquired stock ownership in 13 of the 15 companies and received, under the provisions of the sale-leaseback agreements, virtually all the profits of Canteen Service and Southeastern. Virgil, on the other hand, obtained his executive position with ABC, received 68,500 shares of ABC stock, and acquired the option to purchase 5,000 additional shares of ABC stock at 85 percent of market value. Shortly after the foregoing results were accomplished, Virgil caused petitioners to collectively purchase 11,500 shares of ABC stock, thereby securing to himself, directly and through his ownership of petitioners, the 80,000 shares of ABC stock originally contemplated by the June 30, 1960, agreement between himself and ABC.

The dominant motives of both Virgil and ABC throughout the negotiations which culminated in the sale-leaseback agreements are crystal clear. Virgil sought to obtain ABC stock and an executive position with the company and ABC sought to acquire Virgil's 15 food service companies. In light of these facts, we think it abundantly clear that the sale-leaseback agreements were designed solely to fulfill the personal objectives of Virgil. There was no legitimate business purpose for petitioners to undertake the sale and subsequent leaseback of their tangible assets other than to satisfy Virgil's purpose of shifting income from petitioners to Gladco in order to induce ABC

to go through with the deal. Thus, this is not a case where a corporation entered a sale-leaseback arrangement in order to generate needed cash for business expansion. To the contrary, all the money received by petitioners upon the sale of their tangible assets, together with substantial additional amounts, was used to purchase ABC stock, thus serving no meaningful business purpose to petitioners.

Petitioners' position is further weakened by the fact that during the entire negotiations leading up to the execution of the sale-leaseback agreements, the owner of both the lessor (Gladco) and the lessees (petitioners) was the same person, Virgil Gladieux. Petitioners' attempt to transform such an identity of interest into a relationship which petitioners characterize as adverse, transgresses reasonable imagination. All the more so since the facts show that the sale-leaseback agreements were not intended to be ends in themselves but merely steps in an integrated plan to secure to Virgil and ABC advantages which could not benefit petitioners in any meaningful way. From a review of all the facts bearing on this issue, which have been set out at length in our findings, we are convinced that the sale-leaseback agreements in question were not the result of arm's length negotiation between adverse parties and, therefore, we must determine whether the purported rentals were "in excess of what the lessee [s] would have been required to pay had * * * [they] dealt at arm's length with a stranger." *Roland P. Place, supra.*

The terms of the sale-leaseback agreements provided that petitioners were to make purported rental payments to Gladco equal to 10 percent of petitioners' gross sales on and after October 1, 1960, derived from their vending machine business. The agreements provided, however, that if for any annual fiscal period any rent payable to

Gladco would result in a deficit to petitioners' net income, then such rental would be "abated or refunded in such amount as to eliminate such deficit." The contract provided that net income, as used to calculate the existence of a deficit, was to be determined—

> before Federal income taxes and before any salaries or expenses paid to or attributable to Virgil A. Gladieux or any member of his family, and excluding from the determination of such net income any income, loss or expense of * * * [petitioner] from or attributable to marketable securities or any other investment not germane to the operation of the vending machine business of * * * [petitioner].

For the fiscal year ended September 30, 1961, 10 percent of Canteen Service's sales amounted to $165,149.03 and 10 percent of Southeastern's sales amounted to $17,006.69. Inasmuch as the payment of such "rental" would have resulted in a deficit to petitioners' net operating income for that year, the rentals payable to Gladco under the provisions of the January 31, 1961, contract were reduced as to Canteen Service and Southeastern, to $121,172.15 and $12,211.30, respectively. The foregoing amounts were subsequently claimed by petitioners as rental deductions in their tax returns for their fiscal year 1961.

As to the claimed deductions for the period commencing October 1, 1960, and ended January 31, 1961, we failed to perceive how the amounts paid during that period could satisfy the statutory requirements of section 162(a)(3). That provision specifically provides that to constitute a deductible expense, the payment must be—

> required * * * as a condition to the continued use or possession * * * *of property to which the taxpayer has not taken or is not taking title or in which he has no equity.* [Emphasis supplied.]

The sale-leaseback agreements were not executed before January 31, 1961. The language employed in those agreements in no way suggests that petitioners were attempting to sell their tangible assets to Gladco as of October 1, 1960. To the contrary, the opening paragraph of the respective agreements states that petitioner "hereby sells, transfers and assigns to Gladieux Corporation," thereby evidencing an intent on petitioners' part to make a present sale of their assets on January 31, 1961. While it is true that the agreements subsequently recite that Gladco "hereby leases" to petitioners the aforementioned tangible assets "for a term of twenty years from October 1, 1960," the retroactive aspect of this lease provision can in no way convert ownership of petitioners' assets to Gladco. It follows, that petitioners had not parted with title to their tangible assets, at least until the execution of the sale-leaseback agreements on or after January 31, 1961. That being the case, the retroactive payments made by petitioners to Gladco for the 4-month period from October 1, 1960, to January 31, 1961, was for property which petitioners owned. Such payments are therefore not deductible as rentals under the explicit language of section 162(a)(3) of the Code. The fact that payments were designated as "rentals" and Gladco may have had an enforceable contract right against petitioners for the amounts so designated, in no way alters this result. As we stated in *Catherine G. Armston*, 12 T.C. 539, 548 (1949), affd. 188 F.2d 531 (C.A. 5, 1951):

> the mere designation of * * * amounts as rental does not legally characterize them as such. Nor does the fact that as between the * * * [lessor and lessees], the parties to the agreement, the obligation to pay may have been enforceable, render the payment deductible as rent or otherwise * * *

Equally objectionable is Canteen Service's inclusion in its claimed rental deduction of the amount of $28,897.95 which constitutes part of the profits realized by Canteen Service upon the sale of an 8½-acre vacant lot on April 27, 1961. Although Canteen Service paid or accrued this amount on its books as a liability in favor of Gladco, as purported rental under the sale-leaseback agreement, the facts as well as the applicable Code provision fail to support petitioners' treatment of this item as a "rental" deduction. The sale-leaseback agreement provided that the "rental" payment would be equal to 10 percent of Canteen Service's gross sales from its vending machine business, with the further provision that the annual "rental" would not be permitted to cause a deficit in Canteen Service's "net income." The agreement further provided that "net income," as used in the rental formula, would exclude income "derived from or attributable to marketable securities or any other investment not germane to the operation of the vending machine business of Canteen [Service]." Since the foregoing contract provisions were in effect at the time the land in question was sold, the profits derived from its sale could not have been included in Canteen Service's net income for purposes of calculating its "rental" liability to Gladco without violating the express provisions of the sale-leaseback agreement. The fact that the profits so derived were included in Canteen Service's net operating income for purposes of calculating the "rental" payment, lends additional support to the fact that the series of transactions entered into among petitioners, Gladco, ABC, and Virgil in January 1961 were intended to shift virtually all of petitioners' income to Gladco rather than to serve any legitimate business purpose of petitioners. However, an additional and more serious objection arises with regard to petitioners'

treatment of the real estate profits as "rental." Section 162(a)(3) of the Code specifically excludes as rental deductions, amounts paid for the use of property where title remains in the taxpayer-lessee. Since we have previously found that the land in question was never sold to Gladco by Canteen Service, and that Gladco at no time held title to such property, any "rental" payments made to Gladco by Canteen Service with respect to profits derived from the sale of that land could not satisfy the relevant statutory provision. Thus, as to the purported rentals paid on the profits derived from the sale of Canteen Service's vacant land, we hold that respondent's disallowance was proper.

In determining the reasonableness of the remaining amounts claimed by petitioners as rental deductions for the fiscal year 1961, one factor which we deem significant is the gross disparity between the price Gladco paid petitioners for their tangible assets and the purported rentals petitioners were required to pay Gladco in fiscal 1961 in order to lease back those same assets. In 1961 Canteen Service transferred its office, warehouse, trucks, cars, furniture, fixtures, vending machines, and related hardware to Gladco for $184,659.85, and yet was required to pay a purported rental of $121,172.15 in order to lease back those same assets for 8 months. For the same year, Southeastern similarly transferred its car, trucks, furniture, fixtures, vending machines, and related hardware to Gladco for $5,109.43, and was required to pay a purported rental of $12,211.30 in order to lease back those same assets for 8 months. It is evident that the payments made by petitioners in 1961 as "rentals" were patently excessive and bore no reasonable relationship to an amount which would be required to be paid as rentals for such assets if the petitioners had dealt with a lessor at arm's

length. *Limericks, Inc.*, 7 T.C. 1129 (1946), affd. 165 F.2d 483 (C. A. 5, 1948). Petitioners contended, however, that since the sale-leaseback agreements further required Gladco to "provide and lease to * * * [petitioners] all additional equipment reasonably necessary," the purported rentals were not unreasonable. Under the contract provision relied upon, the determination of how much, if any, additional equipment "was reasonably necessary" was apparently a judgment which Gladco alone would make. The record discloses that for the period October 1, 1960, through October 3, 1964, Southeastern paid Gladco total "rentals" of $62,487.98, receiving in return, for the period October 1, 1960, through December 27, 1964, "additional equipment" costing Gladco $12,097.91. For the same periods, Canteen Service paid Gladco total "rentals" of $432,835.18, receiving in return "additional equipment" costing Gladco $595,591.12. Thus, Southeastern paid Gladco $62,487.98 to "lease" equipment valued by the parties at $5,109.43 and $12,097.91, for a total amount of $17,207.34. Similarly Canteen Service paid Gladco $432,835.18 to "lease" equipment valued by the parties at $184,659.85 and $595,591.12, or a total of $780,250.97. With regard to Canteen Service, an even greater disparity occurred for the period October 1, 1960, through approximately December 1962. During that period Gladco leased to Canteen Service former assets valued at $184,659.85 plus additional assets costing Gladco $66,537.18, or total assets of $251,197.03. As of September 29, 1962, Canteen Service had paid Gladco $208,176.58 in rentals. The unreasonableness of such rentals is striking. The amounts paid by petitioners were almost sufficient to purchase outright the assets "leased." Considering the gross disparity existing between the value of the properties rented to petitioners and "rentals" obtained by

Gladco under the sale-leaseback agreements, we must reject petitioners' contention that Gladco's obligation to provide "all additional equipment reasonably necessary" for petitioners' vending machine operations justified their otherwise excessive "rentals." We have carefully considered the many alternative contentions presented by the parties respecting the rental issue and are satisfied that they do not alter our conclusion that the purported rentals paid by petitioners to Gladco for their fiscal year ended September 30, 1961, were grossly excessive, did not represent the fair rental value of the assets leased, and would not have been "required" to be paid by petitioners had they negotiated at arm's length with an adverse party. Having so concluded, we must hold that the amount respondent determined to be the maximum petitioners would have been required to pay must stand, since it has not been shown to be patently inadequate. *Roland P. Place, supra.*

ISSUE 2. LOCATION COMMISSIONS.

During their fiscal year 1961, Canteen Service and Southeastern paid or accrued total location commissions of $163,468.56 and $11,221.38, respectively. Of those amounts Canteen Service paid or accrued to Gladco $134,920.68 and Southeastern paid or accrued to Gladco $9,174.57. Of the amounts paid or accrued to Gladco by petitioners, respondent disallowed $74,088.26 as to Canteen Service and $1,593.84 as to Southeastern.

The $74,088.26 disallowed Canteen Service consists of two components, location commissions paid or accrued to Gladco for sales at LOF Glass and Toledo Scale, and location commissions paid or accrued to Gladco for "all other business." The amount of the disallowances attributable to the LOF Glass and Toledo Scale business was

$69,429.16, which constituted the entire location commissions claimed by Canteen Service as to those customers. The remaining amount disallowed, $4,659.10, constituted the excess in location commissions for Canteen Service's accounting periods beginning October 1, 1960, and ending February 20, 1961, on all Canteen Service's other business as computed under the rates set forth in the January 31, 1961, agreement between Canteen Service and Gladco, over the rates in effect under the May 10, 1946, agreement.[16] The $1,593.84 disallowed Southeastern constituted the excess in location commissions, for its entire 1961 fiscal year, as computed under the rates set forth in the January 31, 1961, agreement between Southeastern and Gladco, over the rates in effect prior to that agreement.

Respondent has thus disallowed location commissions which fall into two categories. The first category is composed of the disallowance of all location commissions paid or accrued to Gladco by Canteen Service for sales at Toledo Scale and LOF Glass, for Canteen Service's 1961 fiscal year. The second category covers a partial disallowance of location commissions paid or accrued on Canteen Service's business, other than LOF Glass and Toledo Scale, and all of Southeastern's business, for the period October 1, 1960, through February 20, 1961.

The basic issue is whether that portion of the location commissions paid or accrued by petitioners in their fiscal year 1961, and which has been disallowed by respondent, constituted "ordinary and necessary expenses" to petitioners under section 162(a) of the Code. Petitioners contend, and respondent appears to concede, that the statu-

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[16] Respondent allowed all location commissions claimed on this latter component, "all other business," for the remainder of Canteen Service's fiscal year, February 21, 1961, through September 30, 1961.

tory requirement of "ordinary and necessary" is satisfied provided the claimed deduction is for an expense which is merely "appropriate and helpful" to the development of the taxpayer's business, citing the case of *Commissioner v. Tellier*, 383 U. S. 687 (1966). In applying such a standard to the instant case, it has been necessary to consider a multitude of facts, many of which have been contested by the parties, in an attempt to reconstruct a meaningful fact pattern. After careful consideration of all the relevant facts bearing on this issue, as well as the numerous arguments presented by both parties, we are of the view that respondent's disallowance of petitioners' location commissions must be sustained.

With respect to the disallowance of Canteen Service's commission payments to Gladco for sales at LOF Glass and Toledo Scale, we are convinced that such payments satisfied no meaningful business purpose of Canteen Service, but rather, constituted only a further effort on the part of Virgil Gladieux to transfer virtually all petitioners' income to Gladco and thereby secure to himself an executive position with ABC at a starting salary of $62,500, as well as to acquire 80,000 shares of ABC stock.

Petitioners contend that the location commissions paid to Gladco by Canteen Service for the year in question arose out of a contractual obligation between Canteen Service and Gladco which was negotiated at arm's length in 1946, and was rewritten in 1961 in order to standardize the rate structure on Canteen Service's business, a change allegedly made necessary by the increased number of foods used in Canteen Service's vending machines as well as the different location commission rates prevailing in different geographical areas for the same foods.

We do not question that the 1946 agreement between Canteen Service and Gladco was negotiated at arm's length

between adverse parties. At that time Gladco was owned equally by Virgil and his brother Nelson, and Canteen Service was owned by an unrelated party, Ben Handwork. The weakness in petitioners' contention, however, is that all location commissions in question arose out of the 1961 agreement, not the agreement of 1946, and as we have already determined under issue 1, *supra,* the 1961 agreement was entered into between corporations wholly owned by Virgil and his wife, for the principal purpose of shifting income from petitioners to Gladco and not for any meaningful business purpose as far as petitioners were concerned. This conclusion is further supported by the fact that prior to the 1961 agreement, imposing increased location commissions on petitioners retroactively to October 1, 1960, Gladco had waived all commission payments due from Canteen Service on the LOF Glass and Toledo Scale business. The waivers as to those commission payments occurred at the time Canteen Service began making location commission payments directly to the industrial clients, LOF Glass and Toledo Scale. Thus, for several years prior to the 1961 agreement, Canteen Service was not required to make any location commission payments to Gladco on its LOF Glass and Toledo Scale business. However, in order for Virgil's deal with ABC to be consummated, it became necessary to shift all income of petitioners to Gladco. To accomplish this objective Canteen Service was required to reinstitute location commission payments to Gladco on its LOF Glass and Toledo Scale business, which was, of course, in addition to the amounts Canteen Service was required to pay Gladco as purported rental payments. We can find no reasonable explanation for reinstituting such location commissions except as a further device to accomplish the shifting of all petitioners' income to Gladco. The record specifically shows that at the time Virgil was

negotiating with representatives of ABC, he felt ABC was intending to acquire, by the various agreements, all the operating income of petitioners.

Even more objectionable to allowing Canteen Service's location commissions in question is the fact that not only prior to, but for the year in question, Canteen Service paid location commissions directly to LOF Glass and Toledo Scale for the right to operate vending machines on the premises of those industrial customers. In 1961, Canteen Service paid to those customers the combined amount of $12,401.70 in location commissions. In spite of this, petitioners contend that they are entitled to deduct the further amount of $69,429.16 paid to Gladco as location commissions for vending machine sales on the premises of the same two customers. The record fails to reflect any business or economic need for Canteen Service to make the location commission payments in question, and in light of the fact that Canteen Service was already making payments directly to LOF Glass and Toledo Scale, we know of none. Lacking in any meaningful business purpose we fail to see how the payment of such obviously unnecessary amounts could be "appropriate and helpful" for the development of Canteen Service's business. Accordingly we hold that as to the location commissions paid by Canteen Service to Gladco on the sales at LOF Glass and Toledo Scale for the year in question, petitioners are not entitled to a business expense deduction under section 162(a).

There remains for our determination the correctness of respondent's partial disallowance with respect to location commissions made by Canteen Service to Gladco on sales other than at LOF Glass and Toledo Scale, for the period October 1, 1960, through February 20, 1961, and with respect to location commissions made by South-

eastern to Gladco for the same period.[17] Respondent has disallowed only so much of the foregoing location commissions as exceeded the commissions computed pursuant to the rates in effect under the agreement between Canteen Service and Gladco, dated May 10, 1946. Thus, for the period October 1, 1960, through February 20, 1961, respondent disallowed only $4,659.10 out of $25,999.22 claimed by Canteen Service and disallowed $1,593.84 out of $3,558.36 claimed by Southeastern. Since respondent has allowed petitioners' claimed location commissions, although at the lower rates in effect prior to the 1961 agreements, the only question presented is whether respondent correctly disallowed the retroactive increases required by the 1961 agreements.

Petitioners contend that the location commissions were made retroactive to October 1, 1960, because that was the date, originally contemplated by ABC and Virgil in their agreement of June 30, 1960, when the exchange of Virgil's 15 companies was to be made in return for ABC stock. This fact is apparently relied upon by petitioners to justify making the commission payments retroactive to October 1, 1960. Even conceding that the October 1 date was set for that purpose, which the record does not necessarily support, we think petitioners' position is irrelevant with regard to the payment of location commissions by Canteen Service and Southeastern inasmuch as the limited question for our determination is whether the retroactive payments constituted ordinary and necessary business expenses to petitioners. Thus, while the October 1 date

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[17] Except for Canteen Service's commission payments computed upon sales to LOF Glass and Toledo Scale, respondent allowed all location commissions claimed by petitioners for the period February 21, 1961, through September 30, 1961, at the increased rates contained in the 1961 agreements between petitioners and Gladco.

may have been required in order for Virgil to consummate his deal with ABC, we find no valid business reason in the record for petitioners to retroactively pay increased location commissions for more than 4 months. The record is devoid of any meaningful economic benefit flowing to petitioners for such payments, and consistent with our prior determination, *supra*, we think the retroactively increased rates imposed upon petitioners under their 1961 agreements with Gladco merely constituted a necessary concession on Virgil's part, in order to consummate his personal deal with ABC, irrespective of whether such a result proved "appropriate and helpful" for the development of petitioners' business. Accordingly we sustain, under section 162(a), respondent's disallowance of that portion of petitioners' claimed location commissions computed under the retroactive provisions of their 1961 agreements with Gladco.

ISSUE 3. SURTAX EXEMPTIONS.

Respondent has determined that Southeastern was not entitled to a surtax exemption for its fiscal years ended October 3, 1959, October 1, 1960, and September 30, 1961. In his deficiency notice, dated June 19, 1964, respondent assigned as his reason for such disallowance, the following:

> In your income tax returns for the above taxable years, you claimed a surtax exemption. It is held that pursuant to Section 1551 and/or Section 269 of the Internal Revenue Code of 1954, no such surtax exemption is allowable.

Section 1551 of the Code[18] provides, in pertinent part,

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[18] SEC. 1551. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT.

If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corpora-

(*Continued on following page*)

that if a corporation transfers all or part of its property (other than money) to another corporation which was either created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition, and after such transfer the transferor corporation or its stockholders are in control of the transferee corporation, then the transferee corporation shall not be allowed the $25,000 surtax exemption unless it establishes by a clear preponderance of the evidence that the securing of such exemption was not a major purpose of the transfer. In order that Southeastern's surtax exemption be denied under section 1551, respondent recognizes that there must have been a "transfer of property" from another corporation to Southeastern at the time of its incorporation. Respondent contends that consistent with

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(*Continued from preceding page*)

tion which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269 (b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535 (c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this section, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this section, the ownership of stock shall be determined in accordance with the provisions of section 544, except that constructive ownership under section 544 (a) (2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 269 (b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.

the statutory requirement under section 1551, Canteen Service transferred its eight "Canteen" locations at the Revco Manufacturing Co., in Deerfield, Michigan to Southeastern at a time when Southeastern was not yet actively engaged in business.

While it is true that Southeastern, upon its incorporation in 1956, began operating the eight "Canteens" formerly operated by Canteen Service, that fact does not satisfy the statutory transfer requirement inasmuch as there has been no showing that the "Canteens" transferred to Southeastern were in any way owned by Canteen Service. To the contrary, Automatic owned the vending equipment used at the Revco locations and through its franchise, Automatic determined who would operate such "Canteens." The record clearly reflects the fact that Southeastern operated the "Canteens" at Revco under such a franchise agreement with Automatic. In light of this fact we do not think Canteen Service ever possessed such a property right in the eight "Canteens" which could have been the subject of transfer to Southeastern. That being the case, the transfer requirement of section 1551 has not been met and Southeastern may not be denied its surtax exemption under that statutory provision.

Respondent contends, however, that Southeastern's surtax exemption should also be denied under section 269 of the Code.[19] The pertinent provisions of that section

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[19] SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another

(Continued on following page)

provide that where any person or persons acquire control of a corporation for the "principal purpose" of evading or avoiding Federal income tax by securing the benefit of a deduction or other allowance which such person would not otherwise enjoy, the Secretary may disallow such deduction or other allowance. Upon a consideration of the entire record, we think the facts require us to hold that Southeastern was incorporated in 1956 for the princi-

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(Continued from preceding page)

"corporation, not controlled, directly, or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or His Delegate To Allow Deduction, Etc., in Part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

pal purpose of avoiding Federal income taxes, although in arriving at our determination we recognize that the creation of Southeastern may also have served legitimate business purposes.

In an attempt to convince us that tax avoidance was not the principal purpose of incorporating Southeastern, petitioners rely heavily on Virgil's self-serving testimony which was to the effect that his company's projected expansion into Michigan required the creation of a "local identity" or "Michigan image." We are asked to accord great weight to this conclusion because of the fact that Virgil "has been experienced and successful in business." While the successful expansion of Virgil's vending business in Michigan may have necessitated the use of a "Michigan" corporation, the record does not support such a conclusion.

In 1953 Canteen Service, an Ohio corporation, qualified to do business in Michigan and received authorization from Automatic to operate "Canteens" at Revco's plant in Deerfield, Michigan. Canteen Service continued to operate those "Canteens" until Southeastern began its Michigan operations in 1956. Virgil's testimony, as well as petitioners' briefs, goes to great length to show that after Southeastern began its operations it established headquarters in Michigan, hired two men residing in Michigan to supervise its operations, opened bank accounts in Michigan, and established warehouse and refrigeration facilities in Michigan. While we do not question these facts, the weakness in petitioners' position is that there is no reason shown, and we know of none, which would have forbidden Canteen Service from adopting the same Michigan contacts. Of additional significance is the fact that although Virgil's testimony stressed the importance of a Michigan image, the franchise agreement under which Southeastern obtained virtually all its vending machines,

specifically prohibited Southeastern from using its name on the vending machines in a manner which would give the appearance that Southeastern was the owner of the machines. Thus, at the time of Southeastern's incorporation, both Canteen Service and Southeastern were owned by the same individuals (Virgil and Handwork) in the same percentages (75 and 25, respectively); Southeastern took over virtually the same Michigan business that Canteen Service gave up; both businesses were based upon a franchise with Automatic which provided the necessary "Canteens" for an agreed rental; both corporations were on the 13-period system of tabulating income and expenses, using the same fiscal year; and both corporations used the same street address in Toledo, Ohio, to designate their corporate address on their Federal income tax returns. It is in no way apparent from the record why Canteen Service could not have continued to operate and expand the Michigan business. Virgil's conclusory statement regarding the need for a Michigan image finds no support in the record. Considering his business experience and success, as vouched for by petitioners and revealed by the number and extent of his food service corporations, we think it a fair assumption that he was well aware of the Federal income tax advantages to be gained by the addition of yet another corporation to his already extensive operations. Considering the totality of facts bearing upon this issue, we are satisfied that petitioners have failed to show that the acquisition of an additional surtax exemption was not the "principal purpose" of incorporating Southeastern in 1956. Accordingly we must sustain respondent's disallowance of Southeastern's surtax exemption for the years at issue, pursuant to section 269 of the Code.

Decisions will be entered for the respondent.

APPENDIX C.

STATUTE INVOLVED.

§ 162(a) of the Internal Revenue Code of 1954 states in pertinent parts:

> "Sec. 162(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * *.
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *"

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OCT 27 1969

In the Supreme Court of the United States

OCTOBER TERM, 1969

THEODORE J. GOTTHELF AND TOBY GOTTHELF,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1969

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. 10a-17a) is reported at 48 T.C. 690. The opinion of the court of appeals (Pet. 3a-9a) is reported at 407 F. 2d 491.

JURISDICTION

The judgment of the court of appeals was entered on January 28, 1969. A petition for rehearing, filed after the granting of an extension of time in which to

file, was denied on March 13, 1969. The petition for a writ of certiorari was filed on June 11, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Whether part of the payments petitioner made to his former wife, pursuant to a separation agreement, were fixed by the agreement as sums payable for child support, and were therefore neither deductible by petitioner nor includable in the income of the former wife, pursuant to the provisions of Sections 71 and 215 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 71 and 215 of the Internal Revenue Code of 1954 and of Section 1.71-1 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 7-8.

STATEMENT

Sara Gotthelf and petitioner,[1] Theodore Gotthelf, were married in 1951. They had two children. On March 28, 1958, they entered into a separation agreement. A week later they were divorced. The separation agreement was incorporated by reference into the divorce decree.

The agreement provided that petitioner would pay Sara, as long as she lived and did not remarry,

[1] "Petitioner" refers to Theodore Gotthelf. His wife, Toby Gotthelf, is a party because joint returns were filed.

$12,000 annually in equal monthly installments of $1,000 for her support and for the support, care (including, but not by way of limitation, medical care and expenses), maintenance and education of the children. If Sara remarried, the amount payable would be reduced to $7,000 annually, payable in monthly installments. Upon death, marriage, reaching of twenty-one years of age, or separate residence of a child, the amount payable annually would be reduced by $3,500 for each child. A rider attached to the agreement provided that the agreement would be binding on petitioner's estate to the extent of the payment of $7,000 "for the benefit of the two children, as in this agreement provided for." (Pet. 4a-6a, 12a-14a.)

In his income tax return for the year 1960, petitioner claimed a deduction, as alimony, of the $11,400 paid Sara in that year (Pet. 6a, 14a). Sara included $4,400, as gross income in her return, representing the $11,400 received less $7,000 which she treated as payments for the support of the children rather than as alimony (Pet. 7a, 14a). In the face of this conflicting treatment, the Commissioner of Internal Revenue determined deficiencies against both petitioner and Sara. As against petitioner, the Commissioner took the position that $7,000 was child support and not deductible. In the alternative, to protect the revenue, the Commissioner asserted as against Sara that the full amount was alimony and therefore taxable income to her.

The Tax Court, in a consolidated proceeding in effect sustained Sara's treatment of the transaction by concluding that the agreement, including the rider,

fixed in terms of an amount of money the sum payable for the support of the two children (Pet. 16a-17a). It accordingly held that the $7,000 was neither deductible by petitioner nor includable in Sara's gross income (Pet. 10a-17a). The court of appeals affirmed (Pet. 9a).

ARGUMENT

The decision below, affirming that of the Tax Court, turns on the language of a written agreement providing for payments from a divorced husband to his former wife. It is in accord with decisions of this Court. There is no conflict of decisions or other occasion for further review.

1. Section 71 of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 7) requires a divorced wife who who receives alimony to include the full amount in receives alimony to include the full amount in gross income and Section 215 (App., *infra*, p. 8) allows her former husband an equivalent deduction. As an exception, in Section 71(b), the payments are neither includable in the former wife's income nor deductible by the husband to the extent that the terms of a written agreement "fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband." To come within the exception, the agreement providing for the periodic payments must specifically state the amounts or parts thereof allocable to the support of the children. *Commissioner* v. *Lester*, 366 U.S. 299, 301.

After analyzing the agreement and the rider attached to the agreement, which is undeniably an integral part of the written agreement, the Tax Court concluded that the agreement did "fix, in terms of an amount of money" the sum payable for the support of the two children. The Tax Court's conclusion is fully justified by the express terms of the agreement and was properly sustained by the court below. As the Second Circuit concluded (Pet. 8a):

> The language of the rider binding Theodore's estate to the extent of $7,000 "for the benefit of the two children *as in this agreement provided for*" makes specific that which would otherwise have been left for inference.

Petitioner's contentions based on analysis of the agreement without the rider are misplaced. The simple answer is that the agreement included the rider. No factual basis for a contrary contention exists and none were found by the courts below.

2. Petitioner's reliance upon local law is likewise misplaced. This Court has emphatically stated that it is irrelevant whether, under local law, the terms of a written agreement require that specific amounts be used by the wife solely for the support of the children. *Commissioner* v. *Lester*, *supra*, at p. 304.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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JUNE 1969.

APPENDIX

Internal Revenue Code of 1954:

SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) *General Rule.*—

(1) *Decree of divorce or separate maintenance.*—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

* * * *

(b) *Payments to Support Minor Children.*—Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

* * * *

(26 U.S.C. 1964 ed., Sec. 71.)

SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) *General Rule.*—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71 (d) or 682, the amount thereof is not includible in the husband's gross income.

* * * *

(26 U.S.C. 1964 ed., Sec. 215.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.71-1 *Alimony and separate maintenance payments; income to wife or former wife.*

* * * *

(e) *Payments for support of minor children.* Section 71(a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71 (a), is specifically designated as a sum payable for the support of minor children of the husband. * * * If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 71(a). * * *

(26 C.F.R., Sec. 1.71-1.)

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No. 294

In the Supreme Court of the United States

OCTOBER TERM, 1969

SOUTHEASTERN CANTEEN CO. AND CANTEEN SERVICE CO. OF TOLEDO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinions of the Tax Court (Pet. App. 21–60) and the court of appeals (Pet. App. 1–20) have not been officially reported. They are unofficially reported at P–H Memo T.C., par. 67,183, and 23 A.F.T.R. 2d 69–1362, respectively.

JURISDICTION

The decision of the court of appeals was rendered on May 13, 1969. The petition for a writ of certiorari was filed on June 27, 1969. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254(1).

358-178 -69

QUESTION PRESENTED

Whether the disallowance of deductions for the petitioners' excessive and unreasonable "rental payments" and "location commissions" under a sale and lease-back arrangement with a related corporation is supported by the evidence.

STATUTE INVOLVED

Internal Revenue Code of 1954:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> * * * * *
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * * *

[26 U.S.C. 162.]

STATEMENT

On June 30, 1960, Virgil A. Gladieux and his wife owned all the outstanding capital stock of fifteen related corporations, among which were the two petitioners in this case (Pet. 8). At this time the Gladieuxs offered to transfer their fifteen corporations to ABC Vending Corporation in exchange for 80,000 shares

of ABC stock, an option to purchase an additional 5,000 shares, and ABC's employment of Mr. Gladieux at $62,500 per annum (Pet. App. 3). Because a third party would not permit the transfer to ABC of petitioners' franchises from it, however, the final agreement called for transfer to ABC of only thirteen of the fifteen corporations, excluding petitioners, in exchange for 68,500 shares of ABC stock, the option and the employment arrangement. This transaction was consummafed on January 26, 1961. As of January 31, 1961, one of the thirteen corporations previously owned by the Gladieuxs and now owned by ABC agreed with the petitioner corporations to buy their physical assets at book value and lease these assets back to petitioners at an annual "rental" equal to ten percent of gross sales. In addition, petitioners were to pay increased "fixed-location commissions" with respect to sales made at locations derived through ABC's subsidiary, its affiliates, or Virgil Gladieux. Petitioners promptly used the purchase price of the assets to buy 11,500 shares of ABC stock—bringing the total the Gladieuxs owned, either directly or indirectly through their ownership of petitioners, up to the 80,000 shares initially bargained for (Pet. App. 4–5).

Petitioners claimed deductions for "rentals" and "location commissions" in the amount of their payments under the agreement. These claims were disallowed, in part, by the Commissioner. The Tax Court sustained the Commissioner's determination, holding that the sale and lease-back device had been used merely to funnel the petitioners' profits to the cor-

poration now owned by ABC (Pet. App. 42) and that the "rental" payments were in excess of those that would have resulted from an arm's length negotiation (Pet. App. 47). The Tax Court also held that the "location commissions" were not properly deductible, in substance because they lacked any legitimate business purpose and constituted only a further effort to funnel petitioners' income to ABC (Pet. App. 51). The court of appeals affirmed (Pet. App. 1–20).[1]

ARGUMENT

The only issue in this case is the reasonableness of certain claimed business expense deductions. The issue is purely factual, and the decision below is correct in holding the payments involved to be unreasonable. There is neither conflict among the circuits nor any other reason for review in this Court.

Section 162(a)(3) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." A deduction claimed under that section is allowable, however, only if the amount paid is actually for rent,

[1] The court of appeals reversed the Tax Court's disallowance of surtax exemptions petitioners claimed (Pet. App. 18–20). The government has not sought review of this issue, decided favorably to petitioners, since it involves only evidence questions.

rather than for something else in the guise of rent. *Place* v. *Commissioner,* 17 T.C. 199, 203, affirmed, 199 F. 2d 373 (C.A. 6), certiorari denied, 344 U.S. 927. Although there is no express requirement that amounts claimed as rental deductions be reasonable in amount, it is well settled that where a close relationship exists between lessor and lessee, there must be a determination whether or not the lease was negotiated at arm's length. *Stanwick's, Inc.* v. *Commissioner,* 15 T.C. 556, affirmed, 190 F. 2d 84 (C.A. 4); *Midland Ford Tractor Co.* v. *Commissioner,* decided December 17, 1958, 17 T.C.M. 1060, affirmed, 277 F. 2d 111 (C.A. 8), certiorari denied, 364 U.S. 881; *Potter Electric Signal & Mfg. Co.* v. *Commissioner,* decided February 26, 1960, 19 T.C.M. 160, affirmed, 286 F. 2d 200 (C.A. 8). If it is determined, as here, that the lease was not so negotiated, there is a further inquiry as to whether the amount paid for rent was in excess of the amount that the lessee would have been required to pay had he dealt with a stranger. *Place* v. *Commissioner, supra.*

Viewing the evidence as a whole, the courts below reasonably concluded that the rentals petitioners paid under the sale and lease-back agreement were unreasonable and bore no relationship to the fair rental value of the leased equipment (Pet. App. 5–9, 39–49), and that petitioners' payment of the excessive rentals and location commissions reflected their owners' attempt, by funneling their profits to ABC, to approximate their original arrangement with ABC (Pet. App. 7–8, 41–43, 53–55). In asserting that these conclusions were factually incorrect (Pet. 27–28), petition-

ers ignore the mandate of the "clearly erroneous" rule enunciated in *Commissioner* v. *Duberstein,* 363 U.S. 278.

These conclusions are not impeached by the court's failure to supply a detailed definition of "arm's length bargaining" (Pet. 28). Courts have consistently—and properly—refused to do so in view of the unlimited number of situations in which the question may arise. See, for example, the Treasury Regulations promulgated under Section 482 of the 1954 Code, which supply some guidelines for determining an "arm's length" allocation of income and deductions between commonly owned or controlled entities. Treasury Regulations on Income Tax (1954 Code), Sec. 1.482(c)(2) (26 C.F.R. 1.482-2(c)(2)). Any necessary protection is provided by the additional requirement of inquiry to determine the reasonableness of rents paid where arm's length bargaining is absent. And the rents involved in this case plainly were unreasonable.

Nor is the treatment below condemnable as "double taxation" (Pet. 25–26). While it may be true that petitioners may not now offset their gross incomes by taking a deduction for the excessive "rents" and "location commissions," it does not follow that the denial of a deduction for a claimed expense item is "double taxation." Excessive rentals are not ordinary and necessary business expenses, and therefore are not deductible as such. *Potter Electric Signal & Mfg. Co.* v. *Commissioner, supra; Midland Ford Tractor Co.* v. *Commissioner, supra.* The fact that there is contractual liability

for the excessive rent makes no difference. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 593.

Petitioners' reliance on *Commissioner* v. *Tellier,* 383 U. S. 687 (Pet. 25), is misplaced. In *Tellier* the question was whether expenses incurred in defense of a prosecution for violations of the securities laws were ordinary and necessary expenses "appropriate and helpful" to taxpayer's business as a securities dealer. In concluding that they were, this Court characterized the federal income tax as a tax upon net income as opposed to a sanction against wrongdoing. But those payments were unquestionably an expense. No such issue is presented here, where the "rental" payments are in reality a device to funnel petitioners' income to a corporation in lieu of a sale to that corporation.

Finally, the decision below does not conflict with *Skemp* v. *Commissioner,* 168 F. 2d 598 (C.A. 7), and *Brown* v. *Commissioner,* 180 F. 2d 926 (C.A. 3). Both the *Skemp* and *Brown* cases turned on a determination that the rents involved were reasonable. Secondly, the rents in those cases were exacted by a lessor who was in no way connected with the lessee. In this case the lessor and lessee were closely related by ownership during the negotiations for the sale and lease-back and, indeed, remained related by ownership, albeit less directly, after the sale and lease-back arrangement was consummated.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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